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ABSTRACT

The special allowance component of the Guaranteed Student Loan (GSL) program was evaluated through research and hearings. Attention was directed to: the experiences of students and eligible lenders; the administrative costs of various types of eligible lenders; financial indicators that accurately reflect the costs of capital; and administrative mechanisms for rapidly disseminating to lenders the quarterly rate of the special allowance. It was recommended that the special allowance formula be retained in its current form. The allowance formula is one of several interrelated loan program provisions that have successfully contributed to lender participation and the supply of loan capital. Changes in any of these incentives would be viewed by lenders as increasing their risks and possibly would decrease their participation in the program. There is strong evidence that any reduction in the special allowance would disrupt the supply of education loan capital and reduce lender participation. There was no conclusive evidence that lender profits from the current special allowance formula are too high. Two papers are appended: "A Review of the Guaranteed Student Loan Special Allowance" (Wharton Applied Research Center); and "Review of Special Allowance Issues" (Applied Systems Institute, Inc.) (Author/SW)

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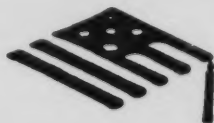
STUDY OF THE SPECIAL ALLOWANCE FORMULA OF THE GUARANTEED STUDENT LOAN PROGRAM

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NATIONAL COMMISSION ON STUDENT FINANCIAL ASSISTANCE

The National Commission on Student Financial Assistance was created by Public Law 96-374, the Education Amendments of 1980. During the congressional deliberations on those amendments, the Congress believed that there was a lack of reliable information and well-informed policy recommendations on many of the most fundamental and important federal student assistance policy issues in postsecondary education. The National Commission was established to correct this situation and to serve as a reliable policy agent for the President and the Congress.

Established in 1981, the National Commission is a bipartisan panel of members of Congress, leaders in the higher education community and representatives of the public. The panel is composed of twelve members, four appointed by the President of the United States, four by the Speaker of the House of Representatives and four by the President Pro Tem of the United States Senate.

The final report of the National Commission is due on July 1, 1983.

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EXECUTIVE SUMMARY

RESEARCH

The special allowance subcommittee of the National Commission on Student Financial Assistance has researched and held hearings on the merits and consequences of changing the method for determining the quarterly rate of the special allowance. It studied, in particular, the factors specifically set out in its mandate, which are:

- the experiences of students and eligible lenders;
- the administrative costs of various types of eligible lenders
- financial indicators which accurately reflect the costs of capital;and
- administrative mechanisms for rapidly disseminating to lenders the quarterly rate of the special allowance.

RECOMMENDATION

The National Commission on Student Financial Assistance recommends that the special allowance formula should be retained in its current form at this time.

FINDINGS

After research and hearings on the subject, the subcommittee is unanimous in its recommendation, which is based on the following principal findings. One, the special

allowance formula is only one of several interrelated loan program provisions that have successfully contributed to lender participation and the supply of loan capital. Changes in any of these incentives would be viewed by lenders as increasing their risks and quite possibly decreasing their participation in the program. Two, there is strong evidence that any reduction in the special allowance would result in disruptions in the supply of education loan capital and reductions in lender participation in the loan program. Three, there was no conclusive evidence that lender profits from the current special allowance formula are excessive or above amounts needed to maintain their participation in the program.

The subcommittee suggests that the adequacy of the special allowance be continually reviewed by this Commission during its life as well as by the Congress and the Department of Education. The volatility of the financial markets and the uncertainties created by the variety of new financial instruments may require future adjustments in the special allowance if an adequate supply of student loan capital is to be maintained.

I. INTRODUCTION TO THE GUARANTEED STUDENT LOAN PROGRAM

The present report is a study of the special allowance component of the Guaranteed Student Loan (GSL) program. The results of this report are relevant within the present framework and environment of the GSL program. If the structure of student financial assistance were to be altered, or, if the Guaranteed Student Loan Program were to be changed, then the conclusions of this report might, of course, be different.

The Guaranteed Student Loan program is the largest single source of funds for students in the United States. During the 1981-82 school year, some 3.5 million students borrowed about \$8 billion to finance their postsecondary education. Since its inception, more than 18 million loans totaling nearly \$30 billion have been issued under the program.

Four principal federal program costs are associated with the Guaranteed Student Loan Program.¹

IN-SCHOOL INTEREST SUBSIDY

While a borrower remains in school and for a grace period (usually six to nine months) thereafter, and for other

¹For a complete description of the GSL Program, its legislative history, growth, and an elaboration of the current program, see National Commission on Student Financial Assistance, Guaranteed Student Loans: A Background Paper (Washington, D. C.: National Commission on Student Financial Assistance, March 1982), from which this section is drawn.

reasons² the federal government pays to the holder of the loan an interest subsidy on behalf of the student borrower. In-school interest payments cease once the loan enters repayment. In fiscal year 1982, the cost to the federal treasury amounted to \$1,064 billion (see Table 1).

SPECIAL ALLOWANCE

The federal government also pays to the loan holder a special allowance each quarter over the life of the loan to compensate for the difference between the statutorily set interest rate charged to borrowers and a market rate of return. The payment to a lender is based on the total dollar value of student loans held. The special allowance must be paid until the loan is fully repaid by the borrower, defaulted, or the debt is cancelled due to bankruptcy, total and permanent disability, or death. In fiscal year 1982, the actual cost to the federal treasury was \$1.85 billion, and the fiscal year 1983 estimate is \$1.26 billion.

GUARANTEES

Lenders are guaranteed for both principal and interest in the case of death, disability, default or bankruptcy of the

²See U.S. House of Representatives, Committee on Education and Labor, Compilation of Federal Education Loans, vol. 3, as amended through December 31, 1980, March 1981, pp. 74-75, for the specific purposes for which repayment deferral is granted.

TABLE 1

Federal Costs for Guaranteed Student Loans, Fiscal Years 1973-1983

(in millions of dollars)

Obligations	1973	1975	1977	1978	1979	1980	1981	1982	1983 est.
In-school interest	209	230	244	249	296	445	629	1,064	1,108
Special allowance payment to lenders	33	87	106	195	401	820	1,365	1,849	1,258
Guarantees and administrative expenses	64	189	198	261	302	333	308	384	509
	306	506	548	705	999	1,598	2,344	3,298	2,865

SOURCE: U.S. Department of Education, Office of Student Financial Assistance.

borrower.³ This guarantee is generally a two-step arrangement in which state agencies agree to insure lenders, and the federal government then reinsures the state guaranty agencies, usually at one hundred percent of the defaulted amount.

ADMINISTRATIVE COSTS

The federal government incurs certain operating expenses in maintaining the GSL program. These costs include those for special allowance and in-school interest payments to lenders, computer support, the staff of the GSL Branch of the Office of Student Financial Assistance in the U.S. Department of Education, the payment of the administrative cost allowance to state agencies, and others.

This report focuses on the special allowance (see Table 1, and note that these cost components have fluctuated significantly in their relative contribution to the total yearly cost of the program).

Special allowance payments to lenders are linked to the 91-day Treasury Bill rate. If market interest rates rise (or fall) so do the obligations of the federal government rise (or fall). Interest rates of the last four years have driven the cost of federal support to unprecedented high levels. Special

³Ibid. Note as defined in Section 430(a) of the Higher Education Act.

allowance payments soared. In fiscal year 1981, special allowance payments amounted to about \$1.5 billion, or 60 percent of total GSL costs, a 700 percent increase in dollars from fiscal year 1978. Total GSL expenditures grew by \$1.7 billion during the same period.

If interest rates, instead of rising far into the double-digit range, had remained at 1978 levels (Treasury Bill rate averaged 7 percent), special allowance payments in fiscal year 1981 would have been approximately \$800 million lower than their actual levels. Thus, almost half of the growth in program expenditures in recent years (\$800 million of \$1.7 billion) can be linked to the increase in market interest rates and its effect on GSL special allowance payments. For each one percent increase in market interest rates, approximately \$200 million must be paid in special allowance obligations annually.

II. RESEARCH METHODS

The National Commission on Student Financial Assistance was created by the Education Act Amendments of 1980 to study and make recommendations on the "special allowance" issue and on 22 other questions defined in the legislation. The Commission, in order to meet its legislative charge, organized into specialized subcommittees with each subcommittee responsible for studying a particular issue with contract studies, consultations with the affected committees and hearings. Each subcommittee then produces a draft report for the consideration of the full membership of the National Commission on Student Financial Assistance. In the fall of 1981, Dr. Kurt Kendis and a team from the Wharton School of Applied Research at the University of Pennsylvania were commissioned to examine the experience of lenders under the current special allowance formula.

The Wharton study⁴ developed a comprehensive random survey of lender attitudes particularly with respect to the

⁴Wharton Applied Research Center, the Wharton School, University of Pennsylvania, A Review of the Guaranteed Student Loan Special Allowance: A Study of Alternative Incentives for Sources of Private Capital to Participate in Loan Programs for Postsecondary Education, prepared for the National Commission on Student Financial Assistance, June 30, 1982, vol. 1, p. 3. (See Appendix A, this paper. A copy of the 3-volume study is available either from Wharton Applied Research Center or the National Commission on Student Financial Assistance.)

profitability of student loans. Concurrently, interviews were conducted with lenders. The results of the survey and interviews were combined with a financial analysis model to estimate the effects of various changes in policy or economic conditions on the supply of student loan funds.

In general, the Wharton study found that:

- the profitability in Guaranteed Student Loans varies greatly with general interest rates and the Treasury Bill rate in particular;

- the structure of the special allowance is not sensitive to variations in cost during the life of the loan (the costs of servicing a loan over its life vary greatly, with the highest costs during repayment. The special allowance formula does not reflect these differences in lender costs); and

- the support mechanisms in place at the state agencies and secondary markets are essential to reduce the perceived risks in the Guaranteed Student Loan program.

In the fall of 1982, the subcommittee requested John Lee of Applied Systems, Inc. (ASI), in Washington, D.C., to examine and report on administrative costs, indices of the cost of capital and other matters (see Appendix B). With the research completed late in 1982, a hearing was held January 5, 1983, to solicit comment upon the adequacy of the research (a copy of the transcript is available from the National Commission).

This brief report is thus based upon the subcommittee's examination of the Wharton study, "A Review of the Guaranteed

Student Loan Special Allowance"; the ASI study, "Review of Special Allowance Issues;" and the hearing held January 5, 1983, in Washington, D.C.

III. THE SPECIAL ALLOWANCE

The present special allowance payment formula provides for a total return to lenders of the bond-equivalent rate for 91-day Treasury Bills, plus 3.5 percent on the total outstanding balance of loans held.* Payments are calculated by the U.S. Department of Education, and made on a quarterly basis. For example, if the Treasury Bill rate is 14.5 percent at a particular time, the total return for GSL lenders would be 18 percent. Thus, for GSL loans with a 7 percent interest rate, the special allowance would be 11 percent, and for 9 percent GSL loans the special allowance would be 9 percent. Fourteen percent auxiliary loans would generate a 4 percent special allowance payment. For loans that have been partially repaid, the special allowance is calculated on the principal amount still outstanding.

*Special allowance: the federal government pays each lender in the GSL Program a quarterly Special Allowance fee throughout the life of a loan. The special allowance is equal to the bond-equivalent rate on U.S. Treasury Bills minus the interest rate on the loan plus 3.5 percent and is paid on the unpaid principal balance of all eligible loans held by the lender. Its purpose is to compensate for the difference between the interest rate the lender receives and the market rate for borrowing (see GSL: A Background Paper).

LEGISLATIVE CHARGE

The legislative charge in P.L. 96-374 to the Commission being examined by the Special Allowance Subcommittee is in Section 491(c):

(3)(A)The Commission shall make a study of an improved method or methods for determination of the quarterly rate of Special Allowances paid under part B of this title which the Commission determines will carry out the objectives set forth in section 438 (a).

(3)(B)The Commission shall make every effort to reach a unanimous decision with respect to the method for determination of the quarterly rate of the special allowances required to be studied by this paragraph.

(3)(C)In developing the method for determination of the quarterly rate of the special allowances under this paragraph, the Commission shall consider--

(i)the experiences of students and eligible lenders under the method in operation during the period of the study,

(ii)the administrative costs of various types of eligible lenders under part B of title IV,

(iii)relevant and widely available financial indicators which accurately reflect the costs of capital invested in programs under such part, or substitute the cost of such capital,

(iv)an administrative mechanism necessary to produce a prompt and rapidly disseminated determination of the quarterly rate of the special allowances, in order to avoid delays in the determination and dissemination of that rate and in the actual payment of the special allowances to eligible lenders, and

(v)such other factors as the Commission considers necessary to carry out the purposes of section 438(a).

This report deals with these sections in turn.

EXPERIENCES OF STUDENTS AND LENDERS

Both the Wharton and ASI studies focus on lender experience with the special allowance. Neither studied "student" experience explicitly; however, the hearings conducted by the Commission's Subcommittee on the In-School

Interest Subsidy can be drawn upon to describe student experience. In that subcommittee's view, the major issues for the student are assured access to capital and the cost of loan capital.

The volume of loans being made would indicate that the students' first concern, access to loans, is being met under the current GSL program structure. For 1981, total loan volume was \$7.7 billion and for 1982, the total loan volume dropped to \$5.88 billion, which reflected changes in eligibility rather than in the supply of loan funds. In 1983, it is estimated that the volume will increase again, to about \$6.6 billion.

From the lenders' view, the paramount concern is the profitability of student loans. Are students assured access to loan capital at reasonable costs under the current structure of the GSL program and do lenders view the current structure as profitable?

It is now apparent from the Wharton research and from testimony given to the subcommittee at its January 5, 1983 hearing that different lenders have very different profit margins. Since participation in the GSL program is usually a very small percentage of their total banking business, they remain in the program so long as the program is perceived as being relatively free from red tape and at least a break-even proposition. Research from the extensive Wharton study clearly indicates that "regulatory change" is perceived as something which could affect their perceived profits. In this time when

banks are undergoing tremendous changes in their cost of money (from the 4 percent to 5 percent savings account rate to the market rate of interest paid on super-NOW accounts) almost any regulatory change is viewed with concern.

The Wharton research examined how possible changes in special allowance monies would alter lender participation in the GSL program. Since special allowances have contributed to both lender profit and lender participation, it is likely that any reduction will produce some reduction in lender profits and reduce the incentive to lenders to participate in the program; and it is also likely that any reduction in special allowance will result in some reduction in the supply of loans. However, the subcommittee does not know precisely what reduction in the special allowance would result in a certain percentage reduction in the supply of loans. A further unknown, based upon the Wharton study, is the amount by which bankers might alter (that is, reduce) student loan availability simply because of changes in any aspect of the incentive structure of the Guaranteed Student Loan program. Kurt Kendis, Applied Research Center, The Wharton School, University of Pennsylvania, reported:

MR KENDIS: The third key finding . . . is that change is perceived as risk. The support mechanisms now in place, the network I referred to of incentives, the state agencies, the secondary markets that are available, are absolutely critical to lender participation in the program. . . .

I think most important is the concept of this network of incentives--the guarantee, the special allowance, state agencies, and the regulatory consistency from year to year is really a network, and that if everything gets changed, you're going to have a whole lot of lenders not interested in participating in the program. Lenders will clearly continue to participate vigorously if nothing is changed whatsoever.⁵

Real pressure to change the formula occurred over the past five years; however, now that dramatic cost reduction attributable to decreases in inflation and the corresponding decreases in the T-Bill rate, are occurring, there is less pressure and need for change. Further, information on the "problem" is based upon experience in what is considered to be an unusually volatile economic environment.

A Network of Incentives

The special allowance is a part of a network of incentives to encourage participation by private or commercial lenders. The isolation of the effects of changing a single component such as the special allowance is extremely difficult. The network of incentives to private or commercial lenders to provide loans is also seen as part of a larger network of incentives to secondary markets and state-supported direct loan agencies to participate in the student loan programs. This entire network is viewed as an interrelated system in which changes to a part affect the whole. To get a sense of the development of this network of incentives, see Table 2.

⁵Taken from Transcript of Proceedings, Special Allowance Subcommittee, January 5, 1983, pp. 13-14; see also Appendix A, pp. 6-7, on the same subject.

TABLE 2

Dates of Change in Special Allowance

Change	Effective Date
o Maximum special allowance 3%	8/1/69
o Provision for payment of special allowance on loans dispersed prior to 8/1/69	10/12/76
o Special allowance formula based on 91-Day Treasury Bill rates	1/1/77
o Rounding of special allowance rate to the nearest 1/8 of 1%	10/1/77
o Increased special allowance rate to 5%	10/1/77
o Calculation of special allowance on "average unpaid principal balance" rather than on "unpaid balance of dispersed principal"	10/1/77
o Added statutory language that the annual special allowance rate would be divided by 4 to obtain the quarterly rate (per prevailing practice)	10/1/77
o Elimination of 5% cap on special allowance	6/1/78
o Guaranteed minimum special allowance of 2.5% for loans based on tax-exempt securities for 7% loans and .5% for 9% loans effective 1/1/81	10/3/80
o New special allowance formulas for 9% and 8% loans	10/3/80
o Reduced allowance rates for loans made or purchased with tax-exempt securities	10/3/80
o Amending of Treasury Bill formula to provide for 14% and 12% PLUS loans	7/13/81
o Elimination of rounding of annual special allowance rate to nearest 1/8 of 1% for loans made on or after 10/1/81	7/13/81
o Redefinition of loans which are eligible for payment of special allowance	7/13/81

SOURCE: U.S. Department of Education; and John Lee, "Review of Special Allowance Issues," for the National Commission on Student Financial Assistance, 1982. See Appendix B.

The network of incentives is also crucial to participation by nonprofit state lending agencies. In 1980, Congress believed that states which made loans based upon the proceeds of tax-exempt obligations were earning excess profits. Therefore, the 1980 Education Amendments reduced the special allowance payment to one-half the rate available to other holders of student loans (e.g., the commercial lenders and the Student Loan Marketing Association [Sallie Mae]). However, the return on student loans to those who use tax-exempt bonds to provide a market (primary and secondary) may be too low under certain market conditions and interest rates. This situation has the potential of reducing loan availability to some students in some geographical areas under various tax-exempt bond market conditions.

The special allowance is part of a network of incentives to the maintenance and enhancement of secondary markets, which serve a vital role in making loan capital available to lenders and, indirectly, student borrowers. Two questions about the role of special allowance arise here. One, is the special allowance adequate to sustain continued operation of Sallie Mae as it moves from low-cost Federal Financing Bank funding to private funding? Two, is the special allowance adequate to maintain the operation of state secondary markets which now operate on one-half the special allowance rates paid to other program participants?

Definitive answers to these questions are not possible. It is clear that both Sallie Mae and state secondary markets

are functioning effectively with the current special allowance. The uncertainties of future financial markets and economic conditions preclude any confident predictions about the future adequacy of the special allowance to sustain secondary markets.

No Change in the Formula

The subcommittee was concerned with whether a change, and, if so, what kind of change, in the special allowance formula is appropriate at this time. Raising or lowering the special allowance rate was of less concern. However, the responses of those who testified before the subcommittee to the question of whether the special allowance formula should be changed indicated that there is lender support for an increase in the rate, if it is to be changed at all.

In response to the issue of whether the special allowance formula should be changed, the Wharton Survey stated:

As an overview of most of these general results it is fair to say that current lenders are happy with the program as it works presently because it works at the present time. Any modification to the program, including the special allowance, is perceived to be a risk that the program may not work as effectively as it does now.⁶

The Administration appears to build upon this view. At the hearing before the subcommittee, Dr. Edward Elmendorf, Assistant Secretary, Department of Education, stated:

We believe that it is very important for the Commission to develop various alternatives to the current Special Allowance and analyze their impact in terms of costs of savings and loan availability before the Commission makes its final recommendations. . . .

⁶See Appendix A, p. 7.

The solution to creating an optimal special allowance formula may be possible only in the context of loan program reform.⁷

The subcommittee, and the Commission, was mandated to recommend unanimously, if possible, modifications to the formula for calculating the special allowance of the GSL program. After new research and hearings on the subject, the subcommittee suggests to the Commission that it recommend at this time no change in the current special allowance formula.

ADMINISTRATIVE COSTS

The Wharton study examined lender profitability, and discovered a wide range of profitability among lenders. The study concluded:

Student loans can be very profitable to lenders . . . under circumstances where average loan sizes are large and costs of operation are controlled. Student loans can be very unprofitable in circumstances where costs are not controlled, or levels of lending reach a point where large investment is required in data processing and the risk of inflation in future years diminishes profitability.⁸

In general, as the Wharton study confirms, administrative costs and profitability vary dramatically among lenders. Further, the costs of administering the loans are greater during the repayment period, when billing and other servicing

⁷National Commission on Student Financial Assistance, Transcript of proceedings of Special Allowance Subcommittee Hearing, Washington, D. C., January 5, 1983, pp. 2 and 8 of Dr. Elmendorf's testimony (available from the National Commission).

⁸See Appendix A, p. 5.

operations are necessary. However, even these costs vary according to the size of the lender's portfolio and the degree to which the operation is automated. (The Sources of Funds subcommittee is exploring lending costs in another aspect of the Commission's research program).

COST OF CAPITAL INDEXES

The subcommittee addressed the issues of whether the Treasury Bill rates were the best indicator of lender costs of capital and whether the special allowance formula should be linked to some other indicator. Witnesses who testified and the ASI Study (Appendix B) agreed that Treasury Bill rates provide a good foundation from which to calculate special allowances because they are widely known, Treasury Bills are virtually risk-free and actively traded, and because T-Bill rates closely parallel the rates of other indicators of costs of capital. However, the testimony from the commercial lenders indicated that linking the special allowance formula to T-Bill rates could result in payments which are lower than the costs of funds under some circumstances. And testimony from the nonprofit lending sector indicated that using T-Bill rates may not provide an accurate portrayal of the feasibility of financing programs through sales of tax-exempt bonds.

In general, testimony and research indicate that while the Treasury Bill rates may not be the ideal measure for all lenders, the evidence suggests that they are fairly

satisfactory. Research and testimony suggested no agreement on a more effective index to measure the cost of capital. Therefore, the subcommittee concluded that no change from the present formula is advisable at this time.

DISSEMINATION OF THE QUARTERLY RATE

The subcommittee noted that lenders must wait for official publication of the quarterly special allowance rate by the Department of Education. The standard delay before the rates are published is about seven days from the end of the quarter, which causes some administrative burden for lenders. However, since the Treasury Bill rate is widely known and the quarterly special allowance can easily be calculated by lenders, this delay does not represent a major inconvenience to lenders.

IV. RECOMMENDATION AND CONCLUSIONS

RECOMMENDATION

THE NATIONAL COMMISSION ON STUDENT FINANCIAL ASSISTANCE RECOMMENDS THAT THE SPECIAL ALLOWANCE FORMULA SHOULD BE RETAINED IN ITS CURRENT FORM AT THIS TIME.

CONCLUSIONS

The Commission's recommendation is based on several findings of the Commission relating to the importance of the present special allowance formula to the stability of the GSL program. These findings are that:

- The administrative costs of lenders (and hence their profits) are a function of several interrelated variables that cannot be described as a simple pattern. A change in any one of these variables made without sufficient understanding of possible effects on other variables could jeopardize the availability of loan capital;
- The bond-equivalent rate for 91-day Treasury Bills is a satisfactory and reliable, if not totally ideal, index of the cost of capital; and
- The quarterly special allowance rate is disseminated with some, although not an excessive, delay by the Department of Education.

The Commission emphasizes that its recommendation that the special allowance be maintained in its current form is based on

its research and the hearing record. Additional research might lead to different conclusions. In particular, a number of issues merit further consideration either by the Commission or in the deliberations of the Congress and the executive branch leading to the reauthorization of the Higher Education Act.

These questions include:

1. Should there be a differential special allowance to encourage adequate availability of small loans?
2. Should there be a differential special allowance on loans during the in-school period and the repayment period in recognition of the differing costs of servicing loans during these two periods?
3. Should there be a differential special allowance based on lender size or the size of a lender's portfolio of student loans recognizing the possibility of efficiencies of scale available to large lenders or lenders with large portfolios of student loans?
4. Is the special allowance adequate or excessive for direct state lenders and state secondary markets which raise capital through the issuance of state tax-exempt bonds?
5. Is the special allowance adequate to ensure a continuing supply of loan capital from commercial lenders in the new environment of bank deregulation and the increased costs of funds?
6. How does the yield on Guaranteed Student Loans compare to the yield that lenders receive on other products in their portfolios?

APPENDIX A

VOLUME 1: EXECUTIVE SUMMARY

A REVIEW OF THE GUARANTEED STUDENT LOAN SPECIAL ALLOWANCE

**A Study of Alternative Incentives for
Sources of Private Capital to Participate in
Loan Programs for Postsecondary Education**

Prepared for: The National Commission on Student
Financial Assistance

Prepared by: The Wharton Applied Research Center
 The Wharton School
 University of Pennsylvania

KURT KENDIS
Senior Project Manager

June 30, 1982

EXECUTIVE SUMMARY

I. PREFACE

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- B. The Data Set and Preliminary Analysis
- C. The Survey Research
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IV. THE STRUCTURE OF LENDER REACTION - A FRAMEWORK FOR ANALYSIS

V. CONCLUSIONS AND POTENTIAL POLICY ALTERNATIVES

VI. CAVEATS AND LIMITATIONS OF THE STUDY

I. PREFACE

"In developing the method for the determination of the quarterly rate of the special allowance ... the Commission shall consider -

- (i) the experiences of students and eligible lenders under the method in operation during the period of the study,
- (ii) the administrative costs of various types of eligible lenders under part B of title IV,
- (iii) relevant and widely available financial indicators which accurately reflect the costs of capital invested in programs under such part, or substitute financial indicators which equitably represent the cost of such capital".

[Section 491 3(A,C) P1 96.374 Enacted October 3, 1980.]

PROBLEM STATEMENT

Escalating federal expenditures appear to be concentrated in an ever-increasing special allowance payment to lenders, and the Congress has never had good empirical evidence as to the need for or optimum level of the special allowance. Researchers and government evaluators alike have not tackled the thorny issue of the supply of private capital for guaranteed student loans, for the structure of supply is a complex combination of multiple types of lenders, guarantee authorities, secondary markets, and attitudes of decision makers which varies considerably from state to state. With regular changes in the program since its early inception, the research needed to analyze supply would be difficult without analyzing all the components within the supply of loan; and this study was designed to do just that.

In reality four studies, a preliminary analysis of existing data was used to construct a sample frame and data set. The data set created a sample frame for a comprehensive random survey of lender attitudes. While Wharton analysts probed into the profitability of loans; key decision makers across the nation were interviewed for their own comments and

perceptions, and this empirical and anecdotal information was assembled to estimate what is likely to occur under certain future scenarios for the guaranteed student loan program. The primary outputs of the study include analysis of existing data on lender activity and structure; a comprehensive survey of attitudes of lenders towards guaranteed student loans as a bank product and as a portion of a portfolio which a bank will hold; a financial analysis model to estimate and calculate the profitability of a guaranteed student loan given a variety of assumptions or information about the lender and the loan, and a simulation model which will estimate potential changes and lending pattern levels across the country under certain changes in federal policy and exogenous economic phenomenon.

At the foundation of each of these outputs of the research is the structure of the study—one which disaggregates lenders by lender type (commercial bank, direct lender, thrift, other); state in which the lender is located, lender size as measured by FDIC data on asset size, and the level of guaranteed student loans within banks' portfolio of other assets. There is no one set of analysis or attitudes for guaranteed student loans throughout the nation. The work done during the research reaffirmed the validity of taking a disaggregated approach in contemplating changes in the student loan program. Likewise the research confirmed that there is a considerable difference for any one lender between the facts concerning loan profitability in student loans and the lenders' perception of profitability of student loans. Thus, at every point in the analysis the survey of attitudes and perceptions has been juxtaposed with profitability analysis and interpreted through the in-depth interviews with decision makers to reach conclusions outlined below.

II. KEY FINDINGS

A. The profitability in Guaranteed Student Loans varies greatly with general interest rates and the Treasury Bill in particular.

For a well-managed banking operation an increase from, for example, nine percent to twelve percent in the Treasury Bill produces nearly a four percent increase in profits due to the nature of the bank operation's fixed costs of servicing loans (mostly data processing). No simple mathematical formulation is possible, however, to alter the special allowance calculation so that profitability will fluctuate evenly with interest rates.

B. There is a consensus that the structure of the special allowance is not sensitive enough to variations in costs during the life of the loan. Although profitability is theoretically sufficient to assure long-range development of servicing capacity and computer support, in reality banks do not plan on such a long perspective and the lenders themselves feel that there is a real incentive not to hold in loans, but to sell them in the secondary market. In fact, our simulations of bank profitability verify the advantages of not holding the loans.

C. The support mechanisms in place at the state agencies and secondary markets are essential to reduce the perceived risks in the Guaranteed Student Loan Program. To lenders, program changes are risks and risks incur cost. Likewise, operating within the aegis of the federal program is a risk, and one that is acceptable because of the efforts of the network of administrative support of the state level.

III. HIGHLIGHTS OF SUMMARY RESULTS

A. General Summary Results

- Although stated attitudes of lenders reveal their reluctance to lend under any change in guaranteed student loans, some modification in the program, including the special allowance, will not alter willingness to continue to supply loans for almost all lenders if other conditions can be met—mostly the stability of the regulatory environment for the future.

Lenders are conscious of escalating costs of processing loans, and that guaranteed student loans can be a very expensive instrument if there is a potential future for regulatory change which would necessitate costly data processing modifications. If the special allowance, for example, were to change and certain stability would be guaranteed either through the state agency and secondary market mechanism or other nonfederal interventions, lenders would be willing to lend at approximately the same levels they are today. Lenders view regulatory change as the main risk in guaranteed student loans.

- The support structure created by state guarantee agencies and secondary markets is essential for the continued participation of many present lenders.

Most lenders agreed, either through the survey or the interviews, that the profitability of the program, and the ease of administration which they now enjoy requires the continued presence and development of both state guarantee agencies and secondary markets. Many lenders even placed this structure above the issue of perceived profitability in their attitude to lend. The technical functional cost analysis identified the existence of a secondary market as a powerful incentive to lend, since in almost all cases the risk of future inflation can be mitigated by the existence of a secondary market to which to sell the loan.

- There is a wide range of profitability among lenders in the guaranteed student loan program, and an even wider variance in their own knowledge of their profitability.

Student loans can be very profitable to lenders (3.5 percent return on assets) under circumstances where average loan sizes are large and costs of operation are controlled. Student loans can be very unprofitable in circumstances where costs are not controlled, or levels of lending reach a point where large investment is required in data processing and the risk of inflation in the future years diminishes profitability. More startling was the result that the lenders surveyed and interviewed often either do not calculate profitability at this level of detail, or are not interested in these kind of calculations because of internal politics within the lending institution. We cite, often, the example of a profit center which makes the loan (and income) and leaves the servicing to another division within the bank.

- There are sets of lenders who are minor participants or not participating at all in the guaranteed student loan program—mostly savings and loans—who would be or should be willing to lend much more than they do now in spite of any changes in future policy or regulation.

The savings and loans institutions in the United States who are lenders in the guaranteed student loan program have found the profitability of the guaranteed student loans to be a welcome addition to their portfolios of home mortgages. Lenders who are thrift institutions revealed that they intend to expand their lending wherever possible, and thrift institutions not yet significant lenders have indicated that guaranteed student loans would be an area for future development. This suggests that even under certain changes in the

special allowance, for example, there would be sets of lenders in the thrift industry willing to provide capital when and where others might not.

- Changes in any of the incentives to lenders would not necessarily result in a long term reduction in the availability or supply of guaranteed student loans, but would cause a short-term displacement much more severe in states where state agencies could not provide interim support for this kind of transition.

With a portion of current lenders acutely sensitive to their perceptions of guaranteed student loan profitability, and yet another portion of lenders desirous of increasing participation without that same sensitivity to perceive profitability it would seem that the supply of guaranteed student loans was assured despite any potential changes. For the long run, it may well be the case that were a change or set of changes in the guaranteed student loan program to occur the eventual new lender growth and participation would replace any attrition from the program; however changes of this nature can not occur overnight except in a situation where a state agency or outside support mechanism provides an enormous level of effort to assure a smooth transition. Practically speaking, the state agency network still leaves areas of the nation without this kind of support and thus a major change in perceived profitability of the loan program would result in a severe short-term disruption of student loan supply for students and their families in these states.

- Special allowance payments notwithstanding, one dominant negative incentive, would be an increase in federal regulatory activity whether through incentive payments or regulatory imposition.

In all portions of this research the lenders expressed their dislike for activities with or for the federal government. The

survey instrument actually received additional voluntary comments concerning the negative incentive surrounding federal intervention; the functional cost analysis showed the perceived processing cost increase surrounding additional federal regulation; the in-depth interviews of decision makers highlighted a fear of potential future federal involvement; and one of the fundamental elements of risk in the calculation of profitability involves a change—unknown at this time but perceived to be potential—in federal regulatory behavior which could provide sufficient motivation for lenders to modify their lender behavior considerably. We have identified one principal component involving the paying of default claims by the federal government, for many lenders perceived future difficulties in student loan defaults which may place pressure on the federal regulators to modify claims procedures. This is a risk, if there is an absence of state reinsurance intervention, which is a considerable concern of almost all lenders surveyed.

As an overview of most of these general results it is fair to say that current lenders are happy with the program as it works presently because it works at the present time. Any modification in the program, including the special allowance, is perceived to be a risk that the program may not work as effectively as it does now. Lenders, it can be said, basically do not like change, potential change, or the risk of potential change and would prefer that their perceptions remain one of future programs stability. For lenders, change is equivalent to risk. They will make decisions based on their evaluation of that risk.

B. Highlights of Summary Results from the Data Sets and Preliminary Data Analysis

The data set included FY 1980 Department of Education call report data combined with FDIC data on bank financial statements. The research was able to provide a description of what type of lender has supplied private capital for guaranteed student loans and where they are located for purposes of analysis and sampling during the survey research. The creation of this data set was a significant outcome of the research and a certain summary descriptions can be provided of both lenders and the structure of the supply of loans across states and sizes of institutions and levels of participation in the guaranteed student loan program.

When reading Table I-A, each cell represents the percentage of total GSLP lending held by banks in the combined category. For example, all large states accounted for 15.2 percent of nationwide GSLP activity, and the data cross the rows represent the percentages associated with each category of bank, in the large states, by bank size and participation level.

This type of analysis was not possible before the creation of this data set.

C. Summary of Results from Questionnaire Survey

With the construction of a data set combining Department of Education Call Report data for FY 1980 and FDIC data on bank financial condition we are able to describe, for the first time, the characteristics of those lenders that have provided private capital for student loans during the life of the program. These analyses included basically

The Structure Of Student Loan Supply

Percentage Share Of Total GSL Lending FY 1980-81

Lender Type - Size ² State Agency Status ¹ Participation ³	L	L	L	H	H	H	S	S	S	Total
	H	A	L	H	A	L	H	A	L	
Large Established State Agencies	1.36	1.50	0.89	2.43	2.29	0.47	4.26	1.68	0.14	15.02
Medium Established State Agencies	0.80	1.68	2.43	3.37	8.33	3.28	8.19	8.24	0.00	36.31
Small Established State Agencies	0.19	0.75	2.25	0.42	2.53	1.82	1.54	2.99	0.09	12.59
New State Agencies	0.14	1.54	6.36	1.68	6.88	5.66	5.62	8.00	0.19	36.08
TOTAL	2.48	5.47	11.93	7.91	20.03	11.23	19..61	20.92	0.42	100.00

1. A - NJ, PA, NY
 B - OH, MI, WI, FL, CN, MA
 C - DC, AK, NV, OK, AR, DE, VT, NM, NC, LA, MN, OR, RI, TN, MD, GA, VA
 D - All other states

2. Total Assets For FDIC files: large - > \$150 million
 medium - \$50 - \$150 million
 small - < \$50 million

3. GSL lending as a portion of total consumer loans: high - total GSL/total assets > .014
 average - total GSL/total assets .00586-.014
 low - total GSL/total assets < .00586

statistically descriptive information which has permitted certain results to be highlighted below; yet the main output of this analysis is the data set itself upon which the survey research was built and other researchers may add with their own investigation in the near future. A discussion of preliminary tabulations reveals a good empirical description of the supply of GSLP.

- 1) Most commercial bank lenders describe themselves as commercial lenders as opposed to consumer lenders, established for over 50 years, and interested in a local market rather than a national market. Banks as we divided them by size and level of participation and analyzed them over each of the 55 states and territories showed very little difference in participation or general descriptive data from area-to-area or size-to-size. Most banks described the guarantee student loan as a 100 percent of their educational loan portfolio, meaning that they do not have their own private loan programs that they offer outside of the federal program.
- 2) Lenders rank in overall importance their attitudes towards the cost of funds, overall profitability, community services, state agencies support, and status of federal legislation as those factors which determine their participation in the program. The questionnaire solicited purely the opinion of the individual or individuals filling out the questionnaire and gave them an opportunity to rank those factors which influenced the amount of funds which a bank was willing to supply for educational loans. Of less importance were issues of default rates, liquidity, administrative costs, pay-back period, and compliance with the Community Reinvestment Act. There was significant difference in these responses based on bank size, and participation level as it related to the banks attitude towards consumers—those banks which viewed themselves more as a consumer-oriented bank were much more willing to treat "cross selling" of other products as a motivation to make guaranteed student loans.
- 3) State agency help was indicated as a very important factor to almost all lenders, with a somewhat lower level of significance for very large banks. The questions were asked of lenders regarding three particular time periods (1972-1975, 1976-1979, 1980-present) and it was the providing of timely information and the preparation of forms at the lender level that really appeared to be a major incentive to lenders for their participation in the program. Very large lenders, however, appear to be less enthusiastic about the influence of

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the state agencies relative to profitability; although even these large lenders note that there is a significant effect of having a state agency in place.

- 4) Lenders all viewed guaranteed student loans as considerably more costly than regular consumer loans, yet the value of the guarantee was noted as significant as a tradeoff to the costliness of processing a guaranteed student loan. A detail of the analysis of the responses indicates that data processing is the component of bank operations which causes the greatest concern for all products, and guaranteed student loans in particular. The escalation of data processing costs and potential for future cost escalation is an issue which is a paramount concern to all lenders no matter what size or level of participation.
- 5) Large banks who were guaranteed student loan lenders indicated that general economic conditions played a significant role in their decision on the level of monies to provide, whereas medium size and small banks did not consider this to be as important a factor. Consistent response patterns from large banks indicated that they provide a different analysis for the twin issues of whether or not to make guaranteed student loans at all, and how many guaranteed student loans to make. Smaller lenders make no such distinction in their revealed analysis.
- 6) As long as current GSL rules and regulations remain the same, revealed lending behavior on the part of the sample population will remain the same. In response to specific questions concerning potential changes in Federal policy lenders universally admitted their willingness to continue to lend as they are at present if there are no changes in the program. These attitudes were measured under various assumptions concerning interest rate fluctuation and all lenders responded similarly in the case that the rules and regulations remain the same.
- 7) For those lenders who utilized secondary markets for all or part of their loan, the availability of these markets was an important factor. Even those lenders not using secondary markets thought that from the year 1980 to the present secondary markets were very important although they had not been important in prior years. The use of secondary markets was very low in early years of the respondents portfolios (less than 3 percent of outstanding loans) but there was a significant difference found in all attitudes towards secondary markets in the time frame on 1980 to present. Small lenders did not have attitudes concerning secondary markets since they are relatively low users of secondary market mechanisms, and large lenders whether they used a secondary market or not

found these institutions to be very important to their attitude to lend in the guaranteed student loan program.

- 8) The analysis of questionnaire response when differentiated by state indicated that the state agency activity was considerably more significant as an incentive for lenders in those states which have had established state agencies for a number of years. Using a differentiation from a 1979 Department of Education study, we were able to separate established state agencies from relatively new state agencies and found that lender response to questions concerning state agency services was considerably more significant in those states where an established state agency existed. The attitudes of small and medium lenders in particular, tended to indicate they relied on the existence of state agencies support as a main incentive for them to participate in the program at all. Lender attitudes towards PLUS loans were not too terribly different from attitudes towards GSL loans, although responses to specific questions concerning PLUS showed a tendency towards item non-response since many lenders are not PLUS lenders at this point in time.
- 9) For questions on plus loans, the questionnaire experience some have non-response since many of the GSLP lenders are not yet PLUS lenders. Under policy considerations, however, PLUS loan activity would decrease with a high degree of significance if any changes are made in the program. This is logical since PLUS represent a new program for lenders.

D. Summary Results of the Functional Cost Analysis

Using 18 variables to evaluate the cost components within the processing of a guaranteed student loan for a lender, the Wharton Functional Cost Analysis Model was established to estimate the interest rate of return on a single loan in a situation where the loan does not default, defaults somewhere during the life of the loan, and is sold to a secondary market. This interest rate of return (IRR) is a present value calculation in a standard methodology familiar to and used by the lending community. The variables include the cost of acquiring the loan, the cost of data processing, the subsidies which are related to the treasury bill rate and include the special

QUESTIONNAIRE RESPONSE

Given the length of the instrument (22 pages, 50 questions) an overall response rate of 52 percent evenly distributed assured representative analysis.

GSL Participation Level					
Lender Size	High	Average	Low	Total	
Large	50 29	50 20	50 26	150 75	Mailed Returned
Medium	50 25	42 29	46 27	148 81	Mailed Returned
Small	52 28	51 28	51 26	154 82	Mailed Returned
TOTAL	152 82	153 77	147 79	456 238	Mailed Returned

Notes:

*The data set was drawn as a random sample from a combination of the FY 1980 Department of Education Call Report and FDIC data on lender financial statements. Institutions with less than \$250,000 in GSL's were not included.

*Lender size: Large = total assets > \$150 million
Medium = total assets \$50 - \$150 million
Small = total assets < \$50 million

*GSL Participation as a share of total assets:

High = > .014
Average = .00586 - .014
Low = < .00586

How to read this chart: For example, the cell in the upper left corner tells us that for lenders whose total assets exceed \$150 million and have more than .014 of those assets in GSL, 50 questionnaires were mailed and 29 returned.

allowance, anticipated inflation, and most fixed and variable costs and fees experienced during the life of the loan. The methodology used was the establishment of a "base case" scenario—arrived at using data received from some participating lenders, and varying critical values in the model to establish a sensitivity analysis on sets of parameters which we assumed to be reasonable under the circumstances. Some preliminary conclusions are readily obtainable from the use of these simulation runs:

- Guaranteed Student loan profitability varies greatly with general interest rates and the Treasury Bill in particular.

Although much of the literature assumed a certain degree of linearity as Treasury Bill rates moved up and down, it is clear that high interest rates make profitability decidedly nonlinear. In fact, as many data processing cost are actually fixed expenditures, some lenders have a real stake in high interest rates as a source of profitability.

Student loans are profitable for lenders who have a well-managed cost frontier; if one assumes a base case internal rate of return of 18.53 percent and a discount rate or acceptable profit of 15 percent that is a yield of 353 bases points above the breakeven point. Nearly three quarters of this profit comes from the front end fee or the cost of making the loan to a student, and almost 95 percent could be attributed to the combination of the front end fee and the special allowance. The next most significant variables of course the size of a single student loan, and in this case the sensitivity of profitability to average note size is logical because the cost of processing a loan are after all fixed costs. In reality lenders often have several

National Commission on Student Financial Assistance
Special Allowance Study

WHAT DETERMINES LENDER PROFITS IN GUARANTEED STUDENT LOANS?

	<u>Responsiveness</u>
Treasury Bill Rate	0.8930
Aggregate Loan Amount	0.0550
Repayment Servicing Cost	- 0.0304
Discount In Sale of Loan To Secondary Market	- 0.0186
Acquisition Cost	- 0.011
Inflation	- 0.0095
Front End Fee	- 0.0024

How to read this chart

The responsiveness of a variable is the direct effect on a bank's internal rate of return. For example, a 1% increase in the treasury bill will increase IRR .893%.

Methodology

Using a typical "base case" scenario of 18 variables, the simulation model was run on six to eight alternatives for each variable and double logarithmic elasticities are used to determine "responsiveness."

notes for a single borrowers or serial note which would increase the average amount of each note.

- A well-managed student loan offers a lender a margin of 250 - 350 bases points¹ above the treasury bill rate—a reasonable level of profitability before taxes for any instrument which a bank may wish to offer.

The caveat for this profitability analysis involves the use of the concept "well managed," since many costs could escalate well beyond the banks ability to maintain a required level of profitability. tax profits and have to be discounted from the banks planning perspective by the tax rate of the bank, and for purposes of this analysis we have not included any components which the banks can use to further increase their profitability such as the use of states subsidies or multiple dispersements. This level of basic profitability is generally acceptable to the lending community.

- Several variables have an enormous effect on the profitability of loans to the bank, and the special allowance is not the most significant of these variables. Special allowance, however, does play a role in profitability.

Within the analysis it appears that the size of the loan, the costs required to establish the loan, and the anticipated inflation rate in combination are just as significant if not more so in combination than the special allowance itself. The range of variations used for the model were all within reason, and it is obvious that the profitability to a bank is much more sensitive to many of these other components than it is to special allowance. The special allowance rate and method of calculation, however, does provide foundation for

¹ 100 bases points = one percent of interest

much of the profitability which a bank will have on its entire portfolio.

- In almost all cases where there is any potential inflation whatsoever, the sale of a student loan to a secondary market, despite an unfavorable price is more profitable to a lender than holding the note itself.

The significance of anticipated inflation over the rather long life of the loan indicates that there is a real risk of exposure to increasing servicing costs in the future to a lender who does not sell a loan to a secondary market. The secondary market calculations were done using current prices, and it is fair to say that this favorable profitability differential will change if there is any significant movement in a special allowance necessitating an increase in secondary market pricing.

- The incidence of default has very little impact on profitability; but the incidence of delinquency has a potential future ability to reduce profitability for a bank.

Of all the variables in the functional costs analysis model which correspond to information gathered during our interviews, the probability of delinquency represents a component in the model which portends some of the fears which the lenders expressed during the interviews. If there is any increase in delinquency in the future the profitability of the loan will drop significantly; particularly in combination with changes in some of the other costs components.

TABLE OF
SUMMARY OF FUNCTIONAL COST ANALYSIS MODEL SIMULATIONS

POLICY ALTERNATIVE	INTERNAL RATE OF RETURN TO LENDER	
	<u>Weighted Portfolio</u>	<u>Sale Case to Secondary Market</u>
BASE CASE	17.06	16.95
Student Int. Rate = 9%	17.06	16.95
Student Int. Rate = 3%	17.06	16.95
Student Int. Rate = 7%	17.06	16.95
Student Int. Rate = 13%	17.07	16.95
Front End Fee = 0%	16.98	16.81
Front End Fee = 5%	17.02	16.88
Front End Fee = 10%	17.06	16.95
Front End Fee = 15%	17.10	17.02
Discount Rate = 12%	13.84	13.37
T-Bill Rate = 10%		
Inflation Rate = 2%		
Discount Rate = 15%	17.24	16.95
T-Bill Rate = 13%		
Inflation Rate = 5%		
Discount Rate = 10%	11.47	11.03
T-Bill Rate = 8%		
Inflation Rate = 3%		
Base Case NPV	228.34	122.91
The base case is fully described in Volume II-B-3 and is representative of current bank policy, costs and assumption. The parameter values for the base case are given in Table . The return is based on a portfolio of loans with default & delinquency probability of the base case. The scale of loans is prior to the repayment period.		

HOW TO READ THIS CHART: Each simulation represents a variation on the base case, for the variable being considered with all the other parameter values maintained at the base level.

POLICY ALTERNATIVE	INTERNAL RATE OF RETURN TO LENDER	
	<u>Weighted Portfolio</u>	<u>Sale Case to Secondary Market</u>
Discount Rate = 12 T-Bill Rate = 10 Inflation Rate = 5%	13.68	13.37
Acquisition Cost = \$ 0	17.31	17.37
Acquisition Cost = \$ 5	17.26	17.28
Acquisition Cost = \$ 10	17.21	17.20
Acquisition Cost = \$ 20	17.11	17.03
Acquisition Cost = \$ 25	17.06	16.95
Acquisition Cost = \$ 50	16.82	16.54
Acquisition Cost = \$100	16.35	15.74
Default Probability = 5%	17.06	16.95
Default Probability = 10%	17.06	16.95
Default Probability = 15%	17.06	16.95
Default Probability = 20%	17.06	16.95
Repayment Servicing Cost = \$0	17.58	16.95
Repayment Servicing Cost = \$1.5	17.32	16.95
Repayment Servicing Cost = \$3	17.06	16.95
Repayment Servicing Cost = \$5	16.70	16.95

Fixed Cost of Default = \$0	17.07	16.95
Fixed Cost of Default = \$3	17.07	16.95
Fixed Cost of Default = \$5	17.06	16.95
Fixed Cost of Default = \$7	17.06	16.95
Fixed Cost of Default = \$10	17.06	16.95
Fixed Cost of Default = \$25	17.03	16.95
Fixed Cost of Default = \$50	16.99	16.95
Delinquency Percentage - (0%, 0%, 0%, 0%)	17.21	16.95
Delinquency Percentage - (1%, 1%, 1%, 1%)	17.17	16.95
Delinquency Percentage - (Base Case) 8%, 4%, 2%, 2%)	17.06	16.95
Delinquency Percentage - (5%, 5%, 5%, 5%)	17.02	16.95
Delinquency Percentage - (10%, 10%, 10%, 10%)	16.83	16.95
In-School Servicing Cost = \$0	17.09	17.01
In-School Servicing Cost = \$0.25	17.06	16.95
In-School Servicing Cost = \$0.5	17.03	16.90
In-School Servicing Cost = \$1.00	16.98	16.78

Probability of payment by government = 80%	17.02	16.95
Probability of payment by government = 85%	17.03	16.95
Probability of payment by government = 90%	17.04	16.95
Probability of payment by government = 95%	17.05	16.95
Probability of payment by government = 100%	17.06	16.95
Lag in Reimbursement = 1 quarter	17.06	16.95
Lag in Reimbursement = 2 quarters	17.05	16.95
Lag in Reimbursement = 3 quarters	17.04	16.95
Lag in Reimbursement = 4 quarters	17.03	16.95
In-School Quarters = 16	17.06	16.95
In-School Quarters = 8	16.94	16.53
In-School Quarters = 24	17.14	16.95
Discount in Sale of loan in secondary market = 0%	17.06	17.61
Discount in Sale of loan in secondary market = 1%	17.06	17.39
Discount in Sale of loan in secondary market = 2%	17.06	17.17
Discount in Sale of loan in secondary market = 3%	17.06	16.98
Discount in Sale of loan in secondary market = 5%	17.06	16.51

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I. Highlights of Summary Results from the Interviews of Key Decision Makers in the Guaranteed Student Loan Program

- Lenders often look at decisions to make guaranteed student loans as a complex process involving bank politics as much as a simple view of loan profitability.

The calculation of profitability in theory is considerably different than how an actual lender looks at profitability. Different divisions within the bank share costs for such items as data processing, and the politics of manipulating the internal cost accounting with the bank overshadows the raw theoretical profitability calculation for a product such as guaranteed student loans. The loans may be profitable for the bank as a whole, but the incomes do not always accrue to the divisions which bear the cost, or when they incur the cost.

- Data processing and the need to develop new data processing capacity seems to be the most significant element in the minds of bank decision makers.

Any step in the processing of guaranteed student loans which requires expenditures on data processing will often overshadow concerns about the special allowance. Indeed, planning for the future data processing needs seem to preoccupy many bank decision makers at this point in time, and although they are always concerned about the income on a particular product, they seem to feel that the special allowance is a manageable variable in their formulation whereas data processing appears to them as clearly unmanageable.

- There are significant numbers of lenders who still do not analyze in any detail whatsoever the costs surrounding the processing of guaranteed student loans.

Looking at the gross yield on a guaranteed student loan and the gross costs as represented by the costs of capital estimate of the bank seems to remain the preoccupation of many lenders nationwide

of all sizes and levels of participation in the guaranteed student loan program. Most of the decision makers who were interviewed admitted that it would be desirable to have both the data and the analytic capacity to look very closely at profitability, yet they were comfortable that if the gross yield remained as high as it is at this point in time there was enough margin in the operations to warrant continued participation in the program. Conversely a perceived significant change in the gross yield—which could be interpreted as a reduction in the special allowance—would concern them a great deal. When pressed as to how much of a change in the gross yield would alter their behavior, most decision makers basically felt that a small change in the special allowance would not change their behavior if all other components of the program remained the same.

- Of utmost concern to all lenders interviewed was the potential for escalating federal interference to be felt on the cost side.

It is a fear of a potential cost escalation due to changing federal rules and regulations which constantly worries the lenders most of all. Indeed, any federal interference or change at all is a negative incentive according to lenders interviewed. One of the real roles of the state guaranteed agencies to most lenders is to assure some considerable bureaucratic distance from the federal government.

- There is a significant potential for additional supply of student loans in the thrift industry. Among savings and loans interviewed during the study it is obvious that the advantages for student loan participation far outweigh any potential difficulties or costs.

Savings and loans are in a critical period the industry which requires new diversification of assets. Guaranteed student loans fit into the mentality of a savings and loans since it is a long-term instrument, and offers the opportunity to retain the current staffing in the thrift institutions who could be transferred to work on guaranteed student loans. However, the thrift industry is very slow to make changes, and rarely if ever calculates the exact profitability of an instrument. Those lenders interviewed felt that it would not necessarily be possible to anticipate any significant change by a large number of savings and loans no matter how attractive guaranteed student loans may be.

- The availability of a secondary market is becoming more and more important for the entire lending community, and for a handful of significant major lenders the existence of the Student Loan Marketing Association with an attractive pricing frontier is absolutely essential for their continued participation.

There are a number of major lenders in the United States who have little or no intention of holding all or most of their student loan portfolio, and for these lenders the existence of a secondary market is absolutely essential. Other lenders feel that the existence of a secondary market provides them excellent political maneuverability within their own institutions to promote continued participation in the student loan program, even if they don't use a secondary market. The consensus is that the existence of secondary markets is absolutely essential for large lenders, or lenders contemplating growth, and is a very desirable incentive for the rest of the population even if they do not use the secondary markets at this point in time. There was also a concern expressed that any change in the profitability of

student loans would probably result in a change in the pricing of student loan secondary market services; and officials of the Student Loan Marketing Association confirmed that not only would changes in the special allowance result inevitably in changes in their pricing policy, but these price changes would probably occur as rapidly as the corporation perceived a need to change the prices.

- For several major lending institutions in the United States there is a perceived need to continue to participate in guaranteed student loans to recoup the investment in computer infrastructure from prior years.

There are a large ^{Number of} guaranteed student loan lenders in the United States who took a position that special allowance payments in the past should be reinvested in a computer system development, and for those lenders the costs of continuing in a program is considerably less now that they have taken an internal accounting loss in prior years. These lenders are relatively insensitive to a profitability analysis of guaranteed student loans, although they performed the analysis regularly and diligently. They are, however, very concerned over potential regulatory change which would make their computer systems either in need of significant investment, or major revisions altogether.

V. CONCLUSIONS AND POLICY ALTERNATIVES

The National Commission can, in the view of the Wharton research team, use the data and analysis in this report to offer several general policy recommendations, the details of which will require careful thought and consideration. The Guaranteed Student Loan Program is presently enjoying, among lenders, the positive effects of incentives enacted by Congress in 1976, 1979, and 1980. We believe that the lending community reacts quite slowly to policy changes, and so that any current changes must contemplate a considerable lag in the response of lenders.

- The structure of the Administrative side of guaranteed student loans, including regular and systematic payments of subsidies and claims, must remain stable.

The survey and analysis concur that perceived regulatory instability represents the highest risk to providers of private capital. Included in this structure are the guarantee agencies and secondary markets, which not only add an element of stability but also provide a degree of distance between lenders and the federal government.

- All incentives, including the special allowance should be sensitive to the type of lender and the general interest levels. Specifically, we recommend a restructuring set of lender incentives.

When interest rates are very high, the same level of special allowance is not necessary for established lenders in established states; and in a low-interest environment the special allowance is not adequate for new lenders in states without established guarantee agencies. The creation of differential incentives is very difficult, and the Commission should advise Congress of the dangers of excessive modifications to the special allowance incentives. However, separating the

special allowance into incentives at origination, in-school period, and during repayment is a more appropriate measure.

- Some additional incentive would be advisable to assure the development of future servicing capacity among lenders; the special allowance does not assure this critical need for the future.

Whether due to internal bank politics, or the possibility that lenders are not aware of the potential magnitude of loan collection in the near future, the consensus among those interviewed was that greater resources must be allocated to developing loan servicing capacity by the lenders. We recommend specific action to address this critical need, since we feel that the special allowance as it is now structured will not necessarily be used for the development of servicing. Two possibilities which we have analyzed include a front-end fee which the lender may keep and potential fiscal incentives for computer software development. There is precedent for tax breaks for computer software development in the 1982 tax law changes, and this could be particularly useful for student loans. A front-end fee would have the dual effect of potentially requiring servicing development and providing an incentive to make smaller loans—something lenders are not willing to do. A front-end fee would also combat lender's desire to trim the costs of creating a loan and perhaps providing information to students, a trend which threatens future timeliness of collections.

- Every effort must be made to disseminate information about GSLP profitability and the need to mitigate future inflation in loan servicing by increasing current investments.

These loan portfolios are profitable, and if well-managed will remain profitable; yet the banking community has been slow to recognize the advantages of GSL lending. Specifically, those lenders who

would be natural additions to the sources of supply—such as the thrift institutions—should be the target of a nation-wide effort for the GSL program.

- An appropriate policy direction in GSLP is to continue to support the network of state agencies and secondary markets and also require more services and effort from them in the future.

In our analysis, the administrative side of GSLP is not a Federal program at all, but now the responsibility of the state agencies. Congress has invested a great deal of money in the development of state agencies and secondary markets. In our view they perform the role of supporting lenders quite well and could do even more. The channeling of differential incentives or fees, such as those outlined above, could be within the scope of responsibilities of the state agencies. Even greater support of lenders and the development of new lenders could be managed by the states, and secondary markets could coordinate the systematic and uniform development of collection procedures. We urge the National Commission to view these entities as a resource to be tapped in the solving of problems in the GSLP—a real potential return on the investment of prior years.

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VI. CAVEATS AND LIMITATIONS OF THE STUDY

In the most perfect of all worlds, an analysis of every lender would be performed to show a complete universe—it was not. We feel its essential to list those potential areas overlooked in this research.

A. Multi-state lending was not analyzed. Within the scope of the work we did not attempt to project the potential of lenders providing loans nation-wide as some money center banks do now. In our view, an environment where several multi-state lenders are present is different from the world as it exists today, yet that scenario is not covered by this study.

B. Credit unions and other lenders were not analyzed. With a few exceptions, credit unions and other lenders are not significant sources of GSLP supply, so they were not a part of the study. The survey and analysis concentrated on commercial banks.

C. The base year of FY 1980 was used for the survey. The Department of Education data for subsequent years is not yet available. However, our interviews endeavored to include new lenders.

D. Very small lenders were excluded. If a bank had not made \$250,000 in GSLP loans they were not included in the data set. Although there are many lenders in this category, those who are still current lenders make more loans than \$100,000 annually and were included in the study.

E. Direct lenders were not included. Since most states which are direct lenders have GSLP as their primary mission, this source of funds was not included as a source of supply which would vary with incentives.

F. The California state agency is treated as a new agency. Although some residual of the prior state organization remained, California is treated in the category of states with new agencies.

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GLOSSARY OF TERMS

<u>Drawdown</u>	Schedule of borrowing by student
<u>Basis Point</u>	One hundredth of 1%
<u>Nominal Rate</u>	Prevailing interest rate in the market (%)
<u>Real Rate</u>	Prevailing interest rate less rate of inflation (%)
<u>Face Value</u>	Amount of loan undertaken (\$)
<u>Discount</u>	Reduction from amount of loan while paying seller of loan (%)
<u>Reimbursement Lag</u>	Delay in reimbursing bank for the principal of a defaulted loan by reimbursing agency (quarters)
<u>Fixed Cost of Default Service</u>	Cost incurred in servicing defaulted loan independent of value of loan
<u>Internal Rate of Return</u>	Measure of profitability of the loan
<u>Secondary Market</u>	Loans can be and are sold by banks to a secondary market—either the Student Loan Marketing Association or state-based organization.
<u>Functional Cost Analysis</u>	The technique used in the financial services industry to measure costs and profits for a product or program.

APPENDIX B

REVIEW
OF
SPECIAL ALLOWANCE
ISSUES

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Executive Overview

There are three sections included in this report:

- o Comparison of Guaranteed Student Loan Value and Changes in the Special Allowance to Lenders;
- o Comparison of Treasury Bills to Other Interest-Bearing Instruments; and,
- o Estimated Cost of Funds for States, Sallie Mae and Commercial Lenders.

The purpose of the report is to describe various aspects of the GSL special allowance.

The first section examines the relationship between changes in special allowance and growth in program value. The following conclusions are reached:

- o There is a correlational relationship between changes in the special allowance and growth in the program. There is not necessarily a causal relationship, since there are other factors which could account for growth in the program.
- o There are three ways in which the equitability of the special allowance could be studied.
 - 1) Develop an index of the average cost of funds to banks and other lenders;
 - 2) Determine the costs of services by collecting information on fees charged by servicing agencies; and,
 - 3) Determine the price paid for loans by the secondary money markets. (A par price indicates the return is adequate.)

The second section compares Treasury Bills to other interest-bearing instruments. The following conclusions are reached:

- o The 91-day Treasury Bill is consistently the lowest interest-bearing instrument.
- o They are widely available and easy to use.
- o They reflect weekly market changes.

For these reasons, Treasury Bills are still the best basis for determining the size of the special allowance.

The third section reviews the estimated costs of funds for states, Sallie Mae and commercial lenders. The conclusions are:

- o The state tax-exempt revenue bond has grown in popularity. The reduction of the special allowance does not seem to have caused a reduction in volume.
- o The yield is difficult to estimate, but proxy measures indicate that there is generally a favorable return to the states.
- o Sallie Mae's cost of money is tied to the 91-day Treasury Bill rate. Therefore, it will receive the same general yield no matter what happens.
- o The cost of funds for commercial lenders varies a great deal by type, size, and location of bank. Their costs also vary by year. It is more difficult to generalize about the yield of Guaranteed Student Loans for commercial lenders.

Care should be taken in interpreting these results. In many instances, proxy measures have been used because actual costs would involve more extensive research than is possible under the current contract constraints. It should also be noted that the estimates do not include business overhead costs.

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I. Comparison of Guaranteed Student Loan Volume and Changes in The Special Allowance to Lenders

Introduction

This report reconstructs the historical relationship between changes in the special allowance for Guaranteed Student Loans and changes in the Guaranteed Student Loan volume. There is a correlational relationship--each time the special allowance has been liberalized, there have been concurrent increases in Guaranteed Student Loan volume. It is not possible, however, to assume that this is a causal relationship. There have been a number of legislative changes to the program which could, with equal plausibility, account for increases in volume. Changes in financial markets and improvements in program management have also been cited as factors which are related to volume growth.

The special allowance has played an important role in making capital available to students, despite the complexities presented by these factors. This role has been characterized by an historical tension between lenders and the Federal Government on what level of return is appropriate on Guaranteed Student Loans. During the early part of the program's history, the argument put forth contended that the return was too low to compensate for the costs of the program relative to other uses for lenders' money. During the latter part of the 1970's, the return on Guaranteed Student Loans has been more adequate. There continues to be concern, however, that the rate of return may not be equitable to both lenders and the Federal Government.

Definition of Special Allowance

The Federal Government pays to the loan holder a special allowance each quarter over the life of the loan to compensate for the differences between the statutory interest rate charged to borrowers and the market rate of return. The payment is based on the total dollar value of student loans held by the lender.

The special allowance is computed by determining the average of the bond equivalent rate for 91-day Treasury Bills auctioned during the previous quarter, by subtracting 3.5 percent from that rate and dividing the result by four. (In the case of eight percent and nine percent loans, 4.5 percent and 5.5 percent, respectively, are subtracted.) The special allowance for loans made with proceeds from tax-exempt bonds is one-half that available to commercial lenders. This distinction was implemented to reduce potential windfalls to states.

There is a minimum special allowance specified by law: it cannot fall below 2.5 percent for seven percent loans; 1.5 percent for eight percent loans; and 0.5 percent for nine percent loans.

Two factors determine the special allowance: the 91-day Treasury Bill rate and the flat percentage addition. The difference between the special allowance and the cost of money to lenders plays a significant role in fixing the lenders' income from Guaranteed Student Loans and Federal government costs. Hence, any discussion regarding the special allowance needs should include consideration of both factors.

Legislative History of the Special Allowance

The procedures used in calculating the special allowance has been changed several times during the history of the program. When the program was initially authorized, no special allowance was given and lenders received a six percent interest rate on the outstanding balance. The borrower's share of the interest rate on the loan was three percent. In 1968, a cost allowance not to exceed one percent was introduced to raise the interest rate to seven percent.

Also in 1968, the three percent Federal interest subsidy paid on behalf of borrowers was eliminated and the interest rate to the student set at seven percent. The first special allowance, at three percent, was instituted in 1969. This, added to the seven percent charged to borrowers, meant that lenders could receive a maximum return of ten percent on

Guaranteed Student Loans. The actual special allowance was to be set quarterly by a committee composed of the Secretary of Health, Education and Welfare, the Secretary of the Treasury and the Director of the Office of Management and Budget. This arrangement held for nine years until the end of 1977.

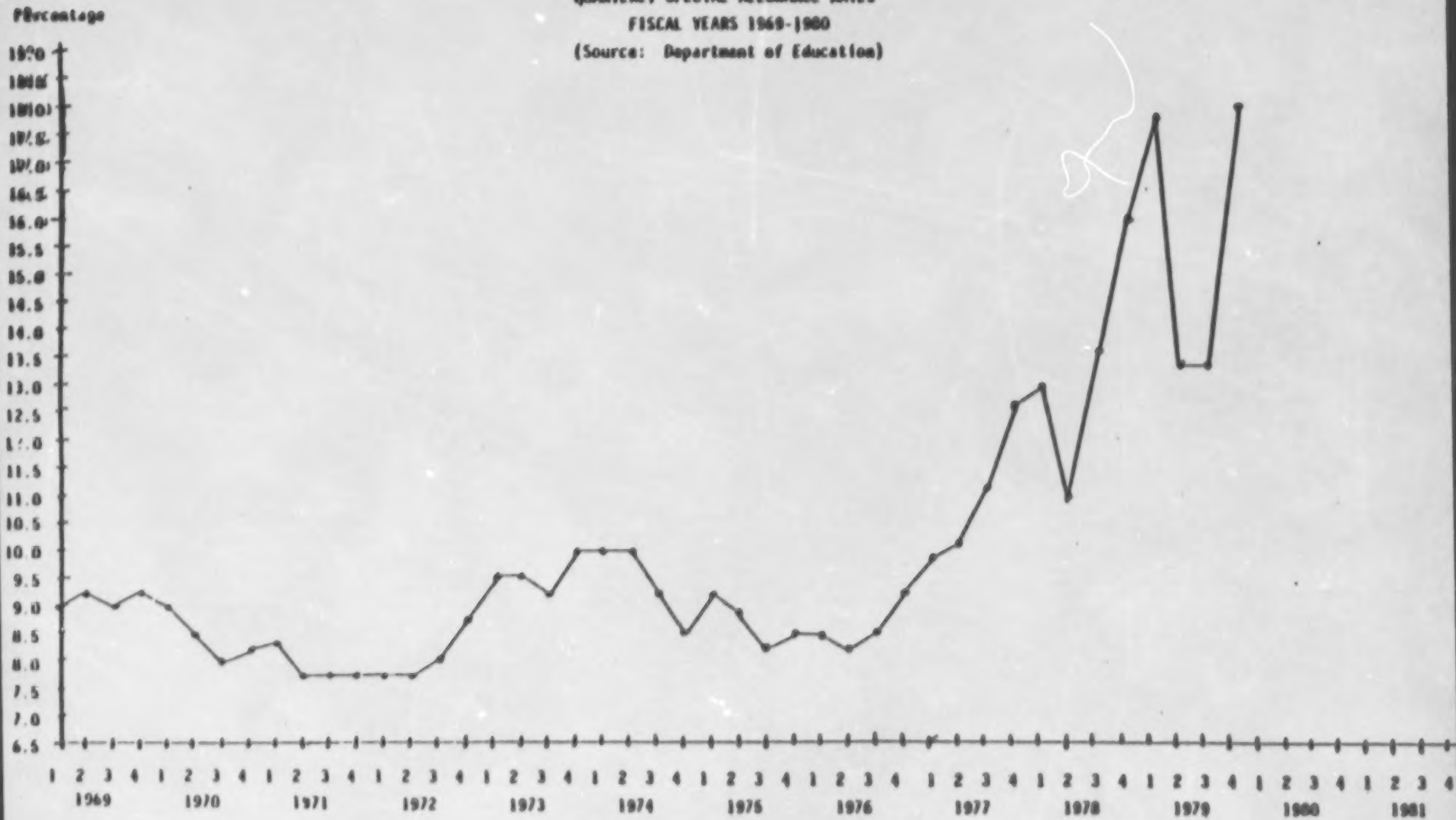
The Special Allowance Committee procedure presented some problems. Chief among these was the fact that the Committee was often late in meeting. Moreover, when it did meet, it would often overcompensate lenders in light of other prevailing interest rates, by raising the special allowance above current rates of return to rectify lender losses during quarters when the Guaranteed Student Loan special allowance was inadequate. The result was an uneven record of interest rates throughout this period. (See Chart 1.)

Beginning in January 1977, the special allowance procedure was changed. In lieu of the committee approach, the level of the special allowance was set for each quarter based on the average 91-day Treasury Bill rate for the previous quarter. This shift away from a committee to Treasury Bill rates was made for several reasons. First, over the long-run, Treasury Bills are among the lowest yielding debt instruments. Further, their yield is determined by market forces. Finally, their rate is unambiguous and easily derived.

Starting with fiscal year 1978, the special allowance cap was raised to five percent. Because of continuing escalation of interest rates, however, lenders indicated that they would be forced to curtail activity in the program if special allowance payments were constrained at the five percent cap. Emergency legislation was passed in 1979 which removed the special allowance cap altogether.

At the beginning of fiscal year 1981, the special allowance for Guaranteed Student Loan funds from the sale of tax-exempt revenue bonds was cut in half. This reduced the special allowance paid to programs so funded. There appears to have

CHART 1
 QUARTERLY SPECIAL ALLOWANCE RATES
 FISCAL YEARS 1969-1980
 (Source: Department of Education)



been no reduction in state participation as a result; in fact, the sale of tax-exempt bonds has accelerated over the last two years.

There have been other modest changes in the program over its history. A minimum special allowance floor (reached when the 91-day Treasury Bills fall below six percent) was introduced as a protection for lenders during periods of low money market rates and as a compensation for fixed administrative costs. Rounding up to the nearest one-eighth of one percent allowed banks without automation to carry out interest calculations more easily. This procedure also resulted in a slightly higher special allowance until its elimination in 1981. Other revisions have involved conforming the special allowance to new loan programs. Table 1 provides specific dates of change in the special allowance.

Other Legislative Changes

Besides the changes in special allowance, there have been other legislative modifications which were designed to increase loan value. The 1976 amendments introduced sweeping GSL program changes. Chief among these was the provision of incentives to states to establish guaranty agencies. It was believed that state agencies could work closely with lenders to stimulate loan volume and improve the administrative procedures in the program. At the same time, the family income ceiling to qualify for inschool subsidy was raised from \$15,000 to \$25,000.

Loan volume continued to accelerate in 1978, when the family income ceiling for subsidy was lifted entirely demand for the program accelerated sharply and lenders were willing to meet the demand. During this period, the amount of money students were allowed to borrow was increased.

By 1980, Congress began to try and reduce program costs. The increased volume combined with high interest rates had resulted in much higher program costs than had been projected. Interest charged to students was increased and the grace period was shortened. Loan volume continued to rise, however.

TABLE 1

DATES OF CHANGE IN SPECIAL ALLOWANCE

<u>Change</u>	<u>Effective Date</u>
o Maximum Special Allowance 3%	08/01/69
o Provision for Payment of Special Allowance on Loans Dispersed Prior to 8/1/69	10/12/76
o Special Allowance Formula based on 91-Day Treasury Bill Rates	01/01/77
o Rounding of Special Allowance Rate to the Nearest 1/8 of 1%	01/01/77
o Increased Special Allowance Rate to 5%	10/01/77
o Calculation of Special Allowance on "Average Unpaid Principal Balance" rather than on "Unpaid Balance of Dispersed Principal"	10/01/77
o Added Statutory Language that the Annual Special Allowance Rate would be Divided by 4 to obtain the Quarterly Rate (per prevailing practice)	10/01/77
o Elimination of 5% Cap on Special Allowance	06/01/78
o Guaranteed minimum special allowance of 2.5%	06/01/78
o New Special Allowance Formulas for 9% and 8% loans	10/03/80
o Reduced Allowance Rates for Loans Made or purchased with tax-exempt obligations	10/03/80
o Amending of Treasury Bill Formula to Provide for 14% and 12% Plus Loans	07/13/81
o Elimination of Rounding of Annual Special Allowance Rate to Nearest 1/8 of 1% for Loans Made On or After 10/1/81	07/13/81
o Redefinition of Loans which are Eligible for Payment of Special Allowance	07/13/81

Source: Department of Education.

During this time, there was an increase in direct state lending with capital secured through the rate of tax-exempt bonds. State agencies were handling an increasing amount of the loan volume as new states instituted state guarantee agencies. There also was increasing interaction between lenders and secondary money markets. All of these events helped increase GSL volume from 1976 to 1982.

Loan Volume

The quarterly volume of Guaranteed Student Loans varies considerably, with the largest volume coming between July 1st and October 1st, just before the school year begins. Because the Department of Education does not keep records of commitments by quarter, and since the volume shifts so dramatically from quarter to quarter, it is probably more useful to use annual data. Chart 2 is the annual rate of Guaranteed Student Loan commitments. The quarterly commitments are found in the Appendix, page 32.

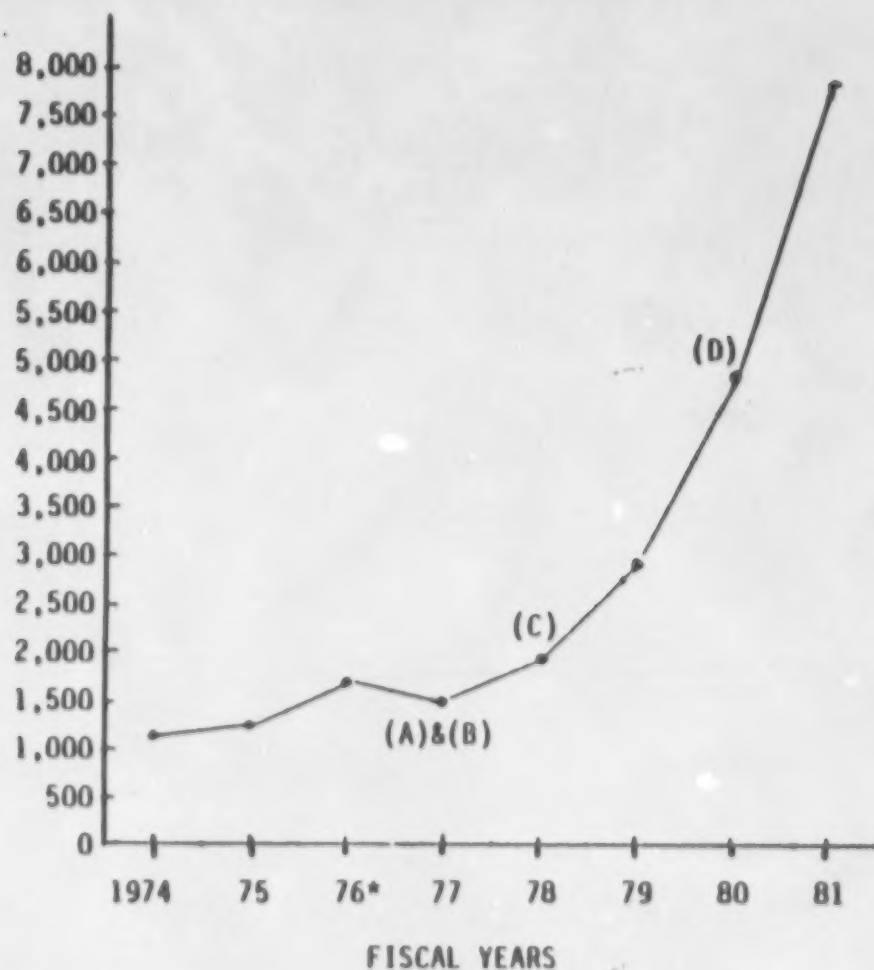
The Program's volume was relatively stable, with slight growth, during the early part of the 1970's. Changes in the special allowance were made primarily in reaction to increasing interest rates. Each special allowance rate proved too low to assure an equitable return to lenders facing the rising cost of money. Changes in the special allowance have been a reaction to increasing interest rates. As interest rates drop, so will the Federal costs of the GSL program. With twenty billion dollars outstanding, a one percent change in special allowance for the year equals \$200 million.

Discussion

It is not possible to determine from historical data if the current special allowance rate is the most equitable from the point of view of lenders and the government. Interest rates have begun to drop in the current year. Because of this and changes in eligibility requirements, Guaranteed Student Loan costs are expected to drop roughly one billion dollars in fiscal

CHART 2
ANNUAL GUARANTEED STUDENT LOAN COMMITMENTS

DOLLARS (x 1,000,000)



- (A) Treasury Bill Used for Quarter Rate.
- (B) Cap Increased to 5%.
- (C) 5% Cap Eliminated.
- (D) Reduction of Special Allowance for Loans Made with Tax-Exempt Bonds.

*Includes Transition Quarter.

year 1982. Current Treasury bill rates are between seven and eight percent. In addition, the cost of funds has changed drastically for banks over the last few years. The results have been mixed--some banks have prospered from inflation, while others have suffered. The deregulation of the financial industry, initiated in 1980, may have unforeseen implications for the Guaranteed Student Loan Program. This uncertainty makes the projection of any past experience problematic for the future.

The administrative cost of servicing loans are expected to increased as more borrowers begin repayment. Currently, servicing costs range between one and two percent of the face amount of the loans. Servicing is cheaper while students are in school than when they are in their repayment period. Because servicing is labor-intensive, it is sensitive to inflationary increases over the life of a long-term Guaranteed Student Loan. This suggests that servicing costs could increase above current rates in the future.

There are ways to measure whether the current special allowance formula is too generous, just sufficient, or inadequate to cover the costs of capital and servicing, while providing a reasonable profit margin. Most of the techniques are indirect. Merely ascertaining whether the current formula is satisfactory to lenders is an inadequate yardstick because it is not in their interest to answer the question directly.

Evaluation of the current formula should be broken down into two parts. First, is the bond equivalency rate of the 91-day Treasury Bill a good measure of the cost of funds to lenders? Second, is the 3.5 percentage point margin in the current formula sufficient to cover the costs of servicing loans?

In order to evaluate the appropriateness of the Treasury Bill rate, it would be necessary to develop an index of the average cost of funds to banks and other lenders. Each lending institution can call upon a large number of sources of funds, including customer checking and savings accounts as well as

Federal funds. A lender's cost of funds is a combination of the various interest rates that must be paid to obtain funds. The cost of funds to lenders will differ from one to another, depending on the characteristics of their portfolios. The comparison of the index to the Treasury Bill rate through time would help estimate the appropriateness of the Treasury Bill as a base for the special allowance. (A rough estimate along these lines is included in a later section.)

The cost of servicing Guaranteed Student Loans is another indicator of the most appropriate special allowance. It would be helpful to examine the cost to banks to service a variety of other loans, especially consumer loans. A more direct way of estimating these costs is to collect information on the fees charged when an organization contracts for servicing. Since there are a number of groups now willing to assume Guaranteed Student Loan servicing for a fee, the price paid should be fairly competitive.

A third method for evaluating the adequacy of the special allowance is to determine the price secondary markets pay to buy Guaranteed Student Loan paper. When a secondary market purchases loans, it may pay the full price of the face value (par), less than the full price (discount), or more than face value (premium). The price paid reflects the secondary money market perception of the adequacy of the return.

In combination, these approaches would help determine if the current rate of return is adequate for the various participants in the Guaranteed Student Loan Program. Each of the approaches is relatively easy to undertake and together would provide a relatively unambiguous estimate of the adequacy of return.

II. Comparison of Treasury Bills to Other Interest-Bearing Instruments

Introduction

The 91-day Treasury Bill was chosen in 1977 as the basis for determining the special allowance for Guaranteed Student Loans. Before that time, the special allowance was determined by a committee representing the Department of Health, Education and Welfare, the Department of the Treasury and the Office of Management and Budget. The Treasury bill was chosen for its several advantages:

- o Over the long run, the Treasury bill is the lowest yielding instrument;
- o The yield is easily available and reported weekly;
- o It is simple, avoiding the necessity of doing calculations after the fact and having to average different rates for different parts of the country;
- o The yield is determined by the market.

The 91-day Treasury bill is a short-term credit instrument encompassing approximately one-quarter of the total gross public debt of the U.S. Treasury. The bills have a low level of interest risk and a nearly zero rate of default. They are highly liquid and may be sold in an active secondary market.

The Federal Reserve, which auctions Treasury Bills every Monday, ranks the bids in order, the highest being honored first, followed by the next highest in order down the line, until the sale is completed. The published Treasury bill rate represents the average of the competitive bids during any particular week.

The interest on Treasury bills is calculated on the basis of the difference between the purchase price and the maturity payment. The nominal rate of interest (that is, the bond equivalency rate) is the interest payment determined as a percentage of the purchase price. Because the interest is calculated on the basis of the price paid and not the face value of the bond, the bond equivalency rate is slightly higher than

the published Treasury Bill rate. The bond equivalency rate for a 91-day Treasury bill with a published rate of 12.758 percent, for example, would be 13.37 percent.

The advantages of using the 91-day Treasury Bill as a basis for the special allowance, are still valid today. Table 1 compares the 91-day Treasury Bill to a number of other regularly collected interest measures. In the table, a "plus" indicates that the alternative was higher than the Treasury Bills in that year; a negative sign indicates the alternative was lower. (The Appendix contains a glossary of the various interest-bearing instruments.)^{8, 9} The only instruments that had similar interest rates over the thirteen-year period were tax-exempt state and local bonds.

Credit markets are linked together because substitution occurs among credit instruments. If there is a high demand for 91-day Treasury Bills, for example, the price will rise and the interest rate fall. In such a situation, it is likely that lenders will be attracted to another market offering greater returns. Such substitutions result in interest rates moving in the same direction.

Chart 1 tracks the 91-Day Treasury Bill rate from 1970 to 1982 in comparison with the prime rate (banks' average rate of interest to favored commercial borrowers) and the discount rate (the rate charged by the Federal Reserve District Banks on loans to eligible financial institutions). The three measures are closely linked. As can be seen from the chart, the 91-day Treasury bill rate exceeded the discount rate on two occasions--in 1970 and 1981. This is also likely to occur in 1982. The 91-day Treasury bill rate has never exceeded the prime rate.

The 91-day Treasury Bill has had a lower interest rate over the last twelve years than have commercial bonds, but a higher rate than state and local tax-exempt bonds. State and local bond rates track corporate bond rates, but at a lower interest level, which reflects the tax-exempt nature of the income derived from these instruments. (See Chart 2.)

Table 1
Comparison of T. Bill to Other Forms of Interest Rates

	70	71	72	73	74	75	76	77	78	79	80	81	82	Number-	Numbers
91 T. Bill	4.39	4.33	4.07	7.03	7.03	5.77	4.97	5.27	7.19	10.07	11.43	14.03	0.60	3	10
6 Mo. T. Bill	0	0	0	0	0	0	0	0	0	-	-	-	0	3	11
1 Year T. Bill	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
Prime Rate	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
Federal Funds	0	0	0	0	0	0	0	0	0	0	0	0	0	0	11
1 Mo. Commercial Paper	NA	NA	0	0	0	0	0	0	0	0	0	0	0	0	13
3 Mo. Commerce	NA	NA	0	0	0	0	0	0	0	0	0	0	0	0	13
6 Mo. Commerce	0	0	0	0	0	0	0	0	0	0	0	0	0	0	12
1 Month Finance	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
3 Month Finance	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
6 Month Finance	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
1 Month C.D.	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
3 Month C.D.	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
6 Month C.D.	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
1 Year Treasury Notes	0	0	0	0	-	0	0	0	0	-	0	0	0	2	11
1-5 Year Treasury Notes	0	0	0	-	-	0	0	0	0	-	0	0	0	3	10
Over 10 Year Treasury Notes	0	0	0	-	-	0	0	0	0	-	-	-	0	5	7
AAA State & Local Bonds	-	0	0	-	-	0	0	-	-	-	-	-	0	7	6
BAA State & Local Bonds	0	0	0	-	-	0	0	0	-	-	-	-	0	6	7
AAA Corporate Bonds	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
AA Corporate Bonds	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
A Corporate Bonds	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
BAA Corporate Bonds	0	0	0	0	0	0	0	0	0	0	0	0	0	0	13
AAA Utility Bonds	0	0	0	0	0	0	0	0	0	0	0	0	0	1	12
Discount Rate	-	0	0	0	-	0	0	0	0	0	0	-	0	3	10

Chart 1
Comparative Interest Rates
1970-1982

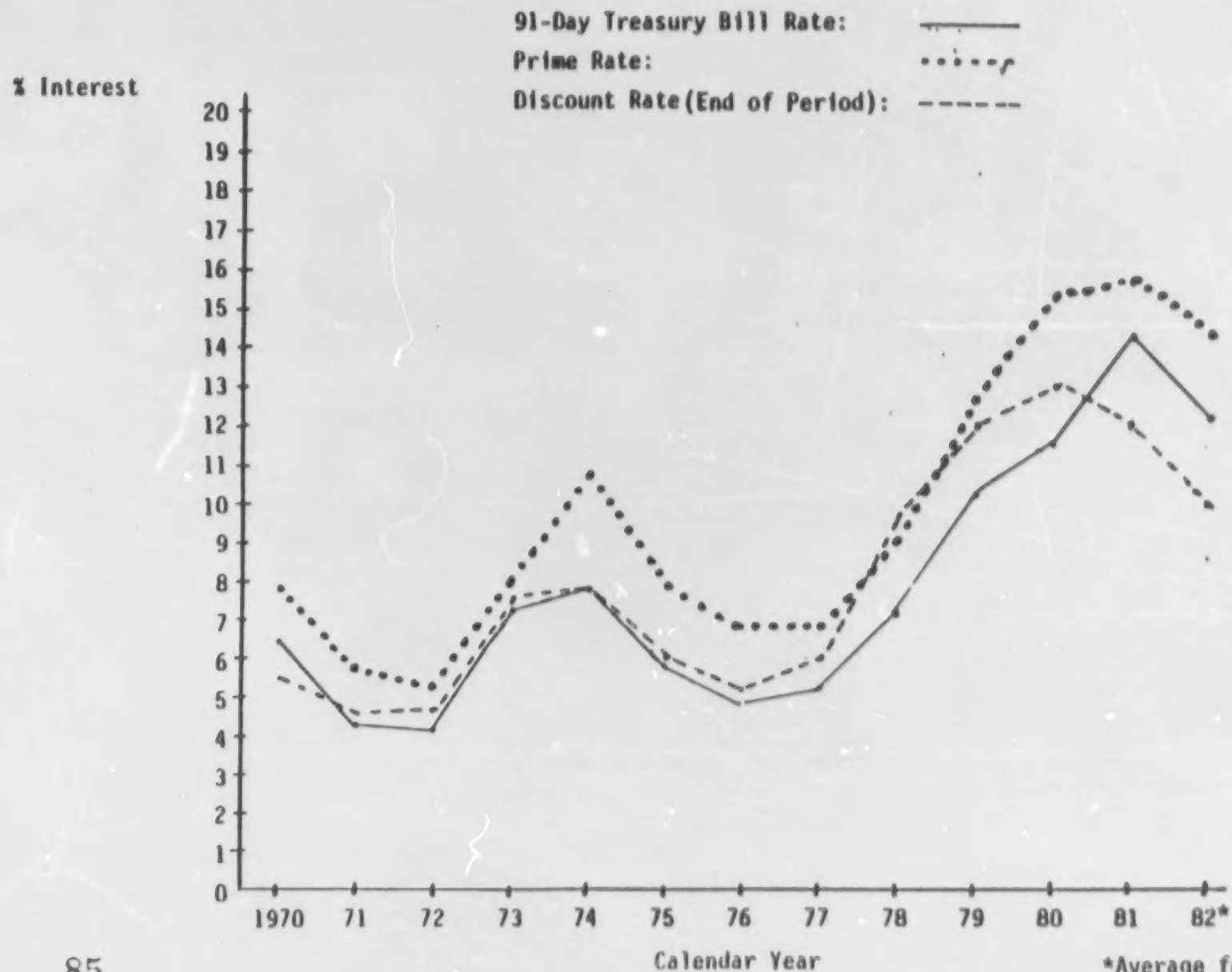
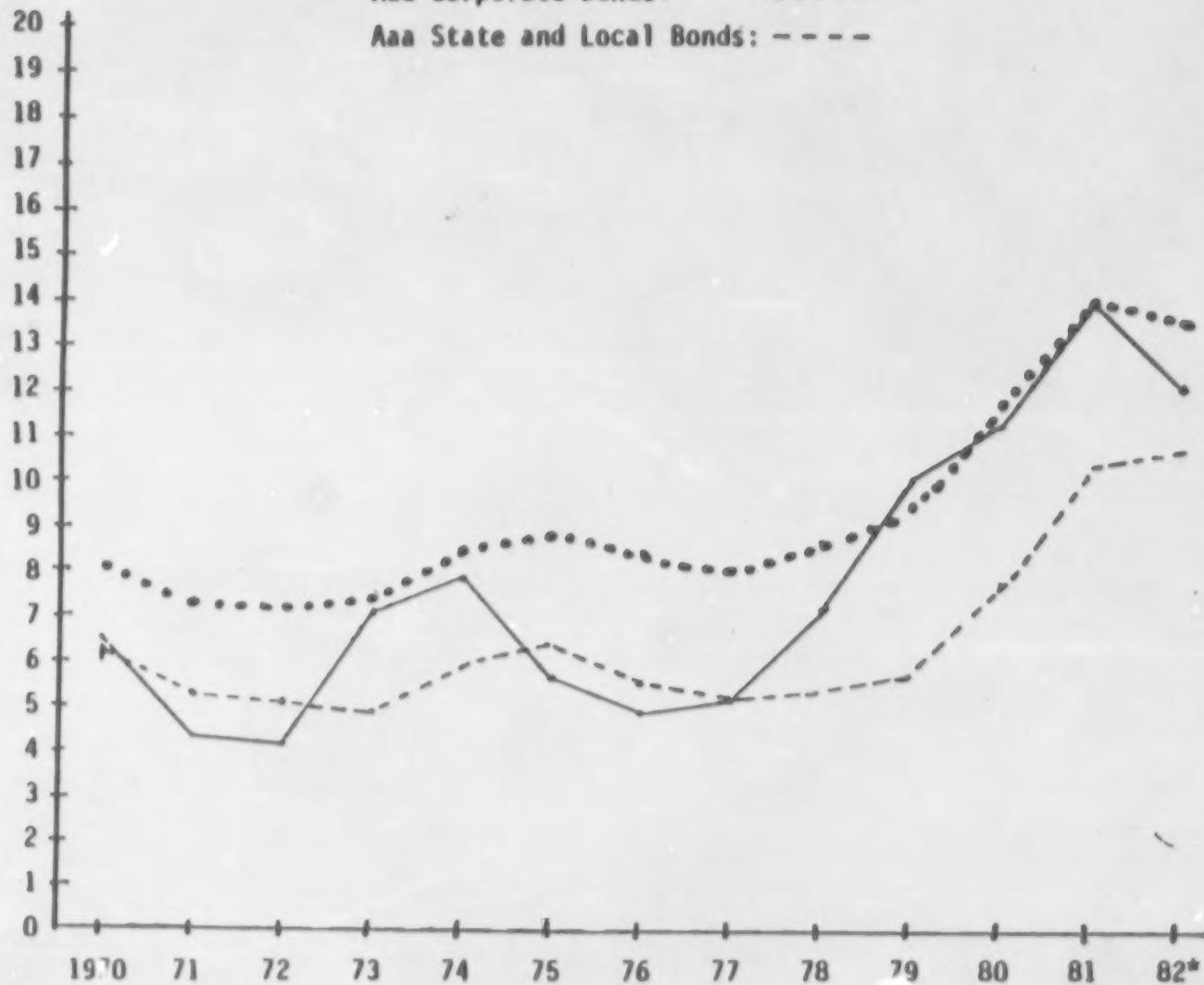


Chart 2 Comparative Interest Rates 1970-1982

% Interest

91-Day Treasury Bill: ———
Aaa Corporate Bonds:
Aaa State and Local Bonds: - - - -



Calendar Year

*Average for 3 Quarters.

To some degree, interest rates reflect the expectations of future costs. When prices rise during inflationary times, interest rates increase. Chart 4 shows the relationship between changes in the Consumer Price Index and 91-day Treasury Bill rates over the last twelve years. The rapid escalation of the 91-day Treasury bill rates reflects inflation, monetary restrictions, and the increasing levels of Federal borrowing. As inflation has cooled and monetary restrictions have been loosened, the 91-day Treasury Bill rates have dropped.

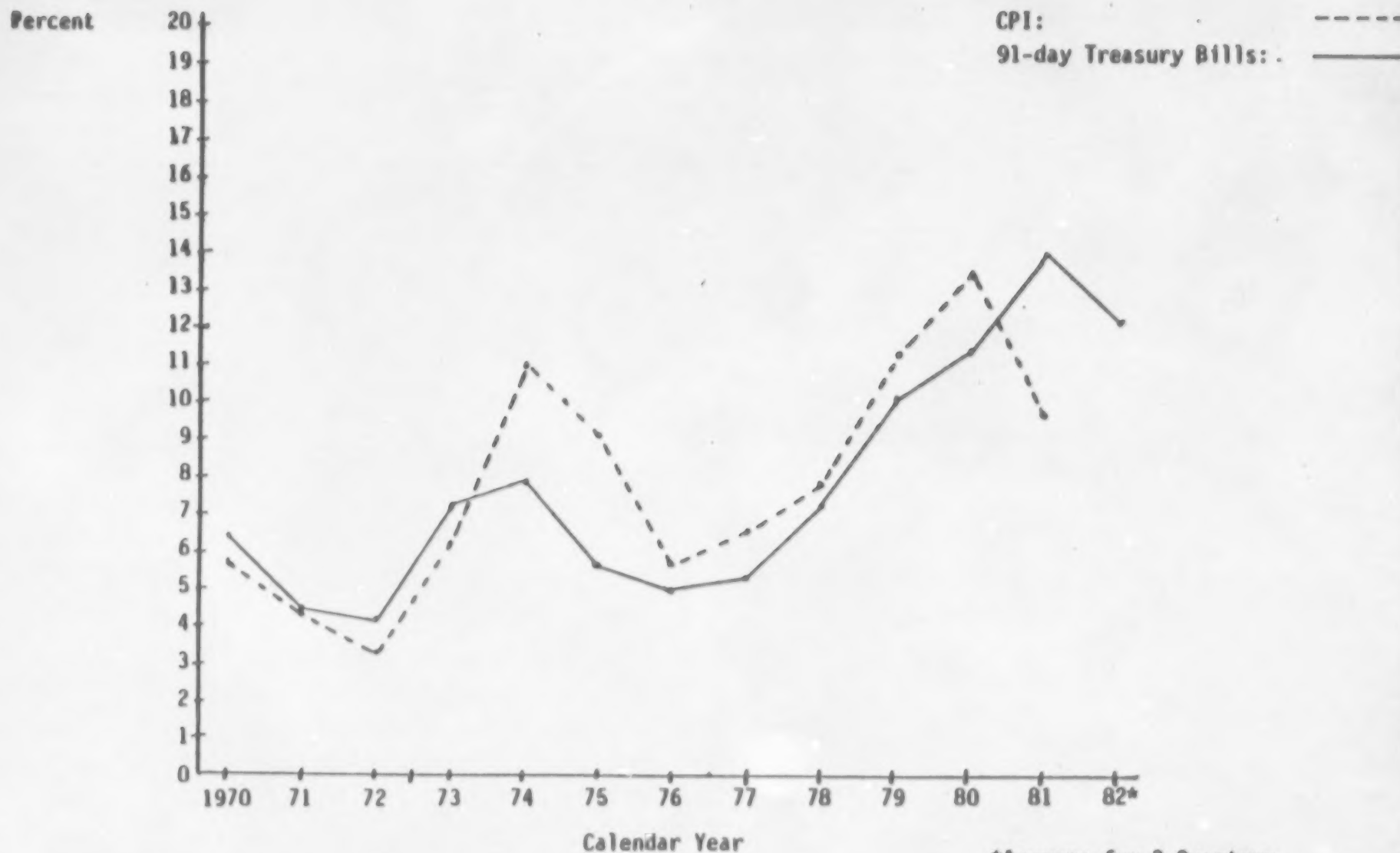
Conclusion

Treasury Bill rates are a good basis upon which to calculate the special allowance. Treasury Bills are actively traded and reflect current supply and demand for funds. Treasury Bills are virtually risk-free. Thus, they command a low rate. Their interest rates are well known in the financial community. In contrast, other interest-bearing instruments are often not as liquid. Published rates for alternative instruments may or may not reflect current market demand for the instruments.

Over the long run, the 91-day Treasury Bill remains the easiest measure of market interest rates available for determining the special allowance for Guaranteed Student Loans. The rather extraordinary events of the last few years have increased short-term interest rates relative to longer-term rates. It appears that a correction is underway, as witnessed by the fact that short-term interest rates are beginning to drop relative to longer-term rates.

Chart 3

Comparison Between Annual CPI Increases and 91-Day Treasury Bill Rates
1970-1982



*Average for 3 Quarters.

III. Estimated Cost of Funds for States, Sallie Mae and Commercial Lenders

Introduction

There are three types of participants in the Guaranteed Student Loan Program (GSLP). Each has a different cost associated with raising capital for the GSLP. States and institutions sell tax-exempt bonds to fund either direct-lending programs or secondary money markets. The second category consists of commercial lenders. Commercial banks, savings and loan companies, credit unions, and insurance companies are all involved as lenders and, in some instances, as secondary money markets. The third category is the Student Loan Marketing Association (Sallie Mae), which provides secondary money market services on a national level.

This analysis is designed to describe, in broad terms, the relationship between the special allowance available to GSLP lenders and the estimated cost of funds to these three program participants. It should be kept in mind that there are wide variations within each category of participants as well as differences among them. Costs are affected by such diverse factors as labor costs, differences in state laws, level of automation, and investment policy.

There also are differences in the costs of funds over time. The recent extreme swings in interest rates have made it difficult to determine what might be an adequate special allowance. A short-term analysis is not sufficient to ascertain the effect of the special allowance for different lenders.

State Tax-Exempt Revenue Bonds

State and institutional bond sales have become an increasingly important part of the GSLP. Currently, 27 states have utilized tax-exempt bonds. The capital from the proceeds is used either to finance a secondary money market or to provide funding for a direct-lending program. As indicated in Table 1,

Table 1
States That Have Sold Tax-Exempt Bonds

	Secondary Market	Direct Lending or Lender of Last Resort
Arkansas	X	X
Colorado	X	
Florida*		
Idaho	X	
Illinois	X	
Iowa	X	
Kansas		X
Kentucky	X	X
Michigan		X
Minnesota		X
Mississippi	X	
Nebraska	X	
New Mexico		X
North Carolina	X	X
North Dakota	X	
Oklahoma		X
Puerto Rico		X
Rhode Island	X	
South Carolina		X
South Dakota	X	
Texas*	X	
Utah	X	
Virginia		X
Washington, D.C.		X
West Virginia		X
Wisconsin		X
Wyoming	X	

Source: Standard and Poor's Corporation, October 1982.

*Includes several regional non-profit corporations.

some states have undertaken both functions. Less than two percent of all GSL's are funded from institutional bonds. Because of this small volume, they are not treated as a separate category.

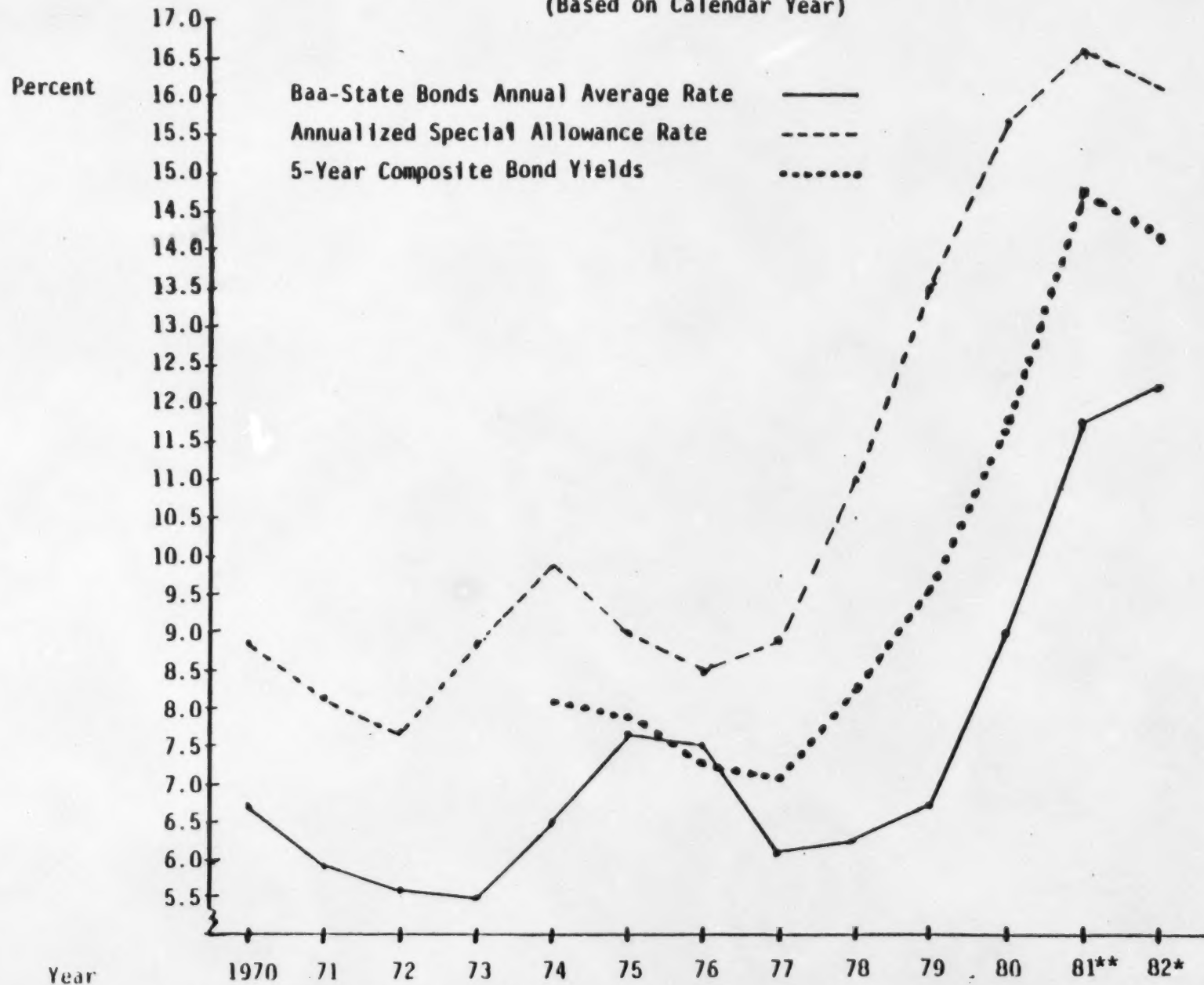
In recent years, the number of issuers of student loan revenue bonds and the dollar volume of such issues have grown markedly. In calendar year 1981, Standard and Poor's rated over \$1 billion in par amounts of student loan revenue bonds. As of September 1982, ratings were maintained on 193 separate issues, representing 33 issuers.

The sale of tax-exempt bonds to finance GSL activity appears to be growing. States have found the yields to be very attractive, especially as they improved during the late 1970's and early 1980's. States have developed a number of financing innovations which lower the costs of capital. Because Guaranteed Student Loans are made for a long time period, it would be costly to repay the bonds over the life of the loans. States, therefore, are buying commitments from third parties to purchase loan portfolios after three years. This allows the bonds to be sold at a lower interest rate. In some cases, demand note financing and variable rate issues have been used to minimize borrowing costs. Some agencies also obtain letters of irrevocable credit and municipal bond insurance to reduce these costs.

Chart 1 shows the relationship between Baa state bond annual average interest (a proxy for state agencies' cost of money) and the special allowance. Chart 1 also compares the special allowance to a five-year composite agency bond yield. It is clear that even with the halving of the special allowance, tax-exempt bonds have remained an attractive option for states which want to finance a secondary money market or provide direct lending. The average difference between the cost of Baa bonds and the return from Guaranteed Student Loans has been 2.943 percent. The high year registered 6.74 percent, while the low year recorded 1.35 percent. It is also probable that, as the short-term and long-term rates return to something closer to their normal relationship, there will be a reduction in the

Chart 1

Cost of Money to State Tax-Exempt Bonds
(Based on Calendar Year)



differential. The 1982 estimates indicate that the difference between tax-exempt bonds and the special allowance may be narrowing.

Student Loan Marketing Association

Until 1981, the Student Loan Marketing Association met all of its debt needs through borrowings from the Federal Financing Bank (FFB). In March 1981, Sallie Mae decided to discontinue further FFB borrowings, either when outstanding FFB debts reached \$5 billion or by September 30, 1982. The final takedown of FFB funds occurred in January 1982. The debt cost of this type of borrowing is fixed at 0.125 percent above 91-day Treasury bill rates.

In May 1981, as a first step in its transition to the private capital market, Sallie Mae began offering discount notes with maturities of up to one year. Discount note sales totaled \$4.5 billion in 1981.

In the latter part of 1981, the first issue of longer-term floating rate notes was sold. The interest rate on these notes is reset weekly, based upon 91-day Treasury Bill rates. Sallie Mae expects to sell \$1 billion of the notes by the end of 1982. This will be in addition to the continued sale of discount rates.

The gross yield on Guaranteed Student Loans is approximately 3.5 percent above the quarterly average 91-day Treasury bill rate. It is estimated that due to commissions and compounding of interest, the cost to Sallie Mae of money is 80 basis points above the 91-day Treasury Bill rate.

The relationship between cost of money and interest is relatively fixed for Sallie Mae, because both are determined by the 91-day Treasury Bill rate. Chart 3 outlines this relationship. It is assumed that, prior to 1981, Sallie Mae was paying 91-day Treasury Bill rates plus 0.125 percent. It is further assumed that during 1981 Sallie Mae was paying Treasury bill rates plus 0.8 percent. This reflects Sallie Mae's move to the private market for financing. Its costs are roughly 50 to 60

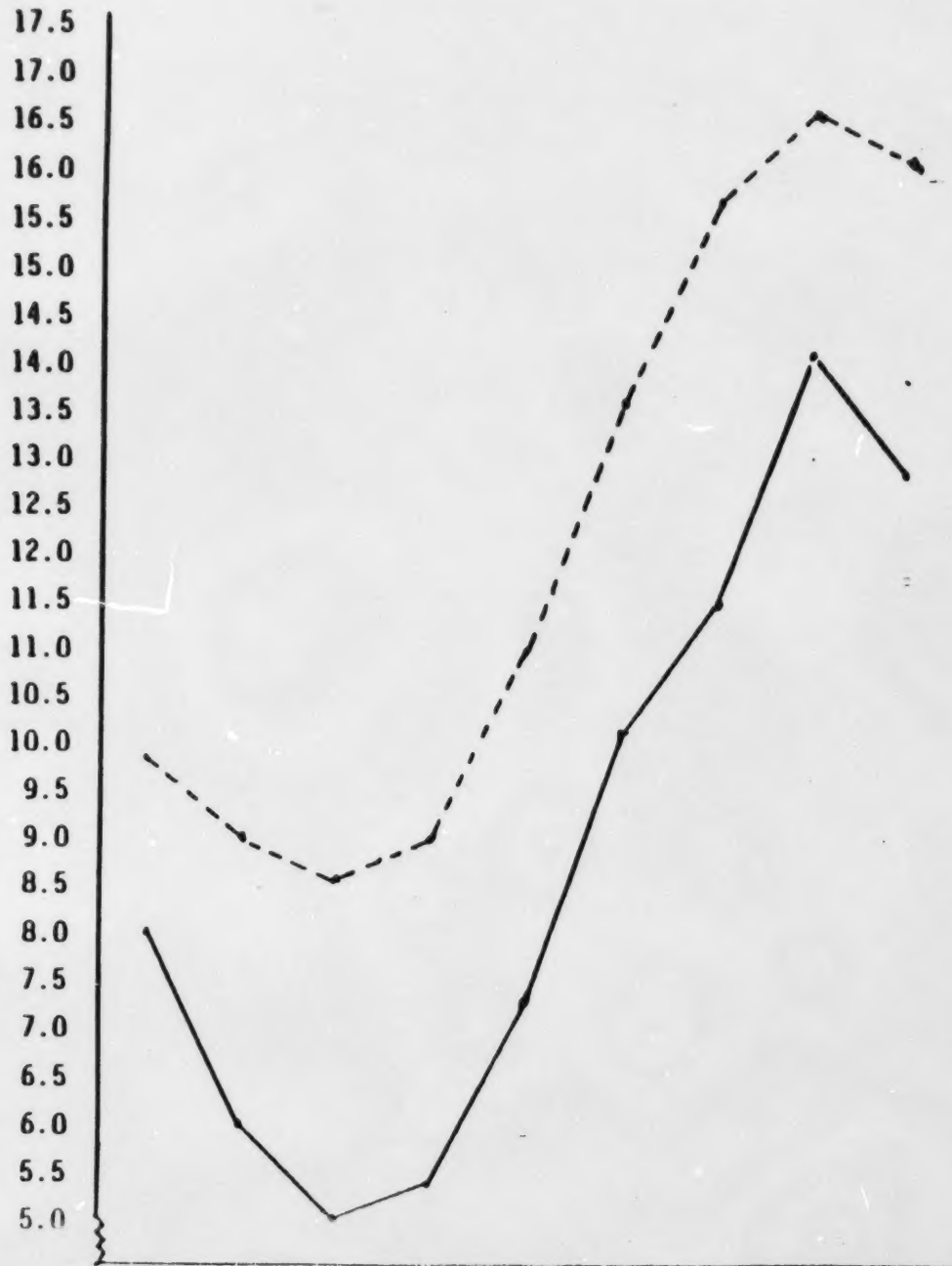
Cost of Money to Sallie Mae
(Based on Calendar Year)

Percent

17.5
17.0
16.5
16.0
15.5
15.0
14.5
14.0
13.5
13.0
12.5
12.0
11.5
11.0
10.5
10.0
9.5
9.0
8.5
8.0
7.5
7.0
6.5
6.0
5.5
5.0

Cost to Sallie Mae

Special Allowance Rate



Source: The Federal Reserve.

*3% Ceiling was raised and Treasury Bills used as backstop.

**Sallie Mae began moving to FFB funding.

basis points higher now than when it worked directly with the 'FFB.' As more of its funds come from the private market, its costs are expected to increase.

Commercial Lenders

The discount rate is used in Chart 3 as a proxy for the cost of funds to commercial lenders. In fact, each lender will have different costs. The differences are systematic, organizational and geographic. For example, state tax rules and lenders' sources of funds differ. The discount rate does, however, provide a base from which the return of Guaranteed Student Loans to the largest lenders can be estimated. As indicated in Chart 3, the rate of return has varied rather sharply over the last few years.

Table 2 provides an alternative estimate for the cost of funds for insured commercial banks. Three years of interest expenses for insured commercial banks were computed from Federal Deposit Insurance Corporation (FDIC) data. Table 2 shows the cost of funds at the 50th percentile. The median percentile was selected as the best measure of central tendency for comparisons.

The column indicating the ratio for all banks is a weighted average based on the number of banks in each asset category. The small number of banks in the \$300 million or more asset group denotes a heavy representation of money center institutions. Thus, the interest expense figures should not be understated for such large banking companies.

For reference purposes, banks with asset bases under \$100 million are considered small; those with asset bases between \$2 and \$5 billion are considered larger regionals; while banks with asset bases in excess of \$10 billion are ranked as money center institutions.

Table 2 clearly points up three factors: (1) there are differences among lenders based on size; (2) there are differences among years; and (3) the estimates of return are different from the discount rate of return proxy used in Chart 3. This

Discount Rates to Commercial Lenders (Based on Calendar Year)

Percent

17.5
17.0
16.5
16.0
15.5
15.0
14.5
14.0
13.5
13.0
12.5
12.0
11.5
11.0
10.5
10.0
9.5
9.0
8.5
8.0
7.5
7.0
6.5
6.0
5.5
5.0

Discount Rate

Special Allowance

Source: U.S. Department of

1974 75 76 77 78 79 80 81 82*

Table 2

Insured Commercial Banks with Total
Assets (in millions of dollars) of:

		<u>Under 5.0</u>	<u>5.0 to 9.9</u>	<u>10.0 24.9</u>	<u>25.0 to 49.9</u>	<u>50.0 to 99.9</u>	<u>100.0 to 299.9</u>	<u>300.0 or more</u>	<u>A ba</u>
Interest expense to Time and Savings Deposits & Borrowings at the 50th percentile	1981	9.15	9.70	10.07	10.45	10.68	10.81	12.14	10
	1980	7.49	7.94	8.21	8.46	8.60	8.75	9.34	8
	1979	6.09	6.31	6.53	6.86	7.07	7.19	7.84	6
Number of Banks	1981	469	1,675	4,557	3,658	2,185	1,284	583	14.
	1980	653	1,911	4,651	3,546	1,969	1,155	545	14.
	1979	830	2,128	4,728	3,371	1,764	1,049	494	14.

Source:

FDIC Bank Operating Statistics

Note: The ratios are based on average figures on all
four Reports of Condition during the year.

Prepared by: Sallie Mae MWD/Credit Analysis
10/18/82

suggests the need to exercise care in estimating the cost of funds to commercial lenders.

Conclusions and Summary

Each participant in the GSLP faces different rates of return, depending on how they are allowed to raise money. The return on Guaranteed Student Loans changes regularly in response to changes in the money market. Between 1977 and 1981, there was a greater return to lenders than during the preceding period.

Caution should be used in developing policy based on the experiences of the last two or three years. It appears that trends in relative returns to the program are changing again this year. Over-reaction in response to recent cost increases to the Federal government could cause an interruption in the participation of lenders.

The measures used in this analysis are only rough proxies of the relative gross return to lenders. As such, they probably overstate the return to lenders. No consideration has been given to other factors which influence the return for GSL lenders. These include the administrative costs of operating the program. A more specific analysis of lender costs was carried out in 1976 (Report to Congress of the Committee on Process of Determining Student Loan Special Allowances, October 1, 1977). They found that there is no simple way to establish the overhead costs of program management. They vary by institution, state, size of program participation and services rendered.

APPENDIX

Glossary

- 1) Certificate of Deposit - An account where funds are placed for a specified time; may be negotiable or nonnegotiable.
- 2) Commercial Paper - Short-term promissory notes, issued by banks, corporations, and finance companies.
- 3) Consumer Price Index (CPI) - A statistical measure of changes in prices of goods and services bought by families of city wage earners and clerical workers. This index is prepared by the Bureau of the Labor Statistics, U.S. Department of Labor.
- 4) Discount Rate - The rate charged by the Federal Reserve District Banks on loans to eligible financial institutions. One of the tools of monetary policy.
- 5) Federal Funds - Short-term (generally overnight) funds borrowed and lent between financial institutions where the funds borrowed (usually deposits held at Federal Reserve District Banks) would not be subject to reserve requirements if borrowed by a member bank of the Federal Reserve System.
- 6) Finance Papers - Short-term promissory notes issued by non-bank finance companies.
- 7) Prime Rate - Interest a commercial bank charges its most preferred customers.
- 8) Treasury Bill - A short-term (one year or less) promissory note, issued by the United States Treasury, secured by "the full faith and credit of the United States." They are sold at a discount, initially through a primary market organized through the Federal Reserve. They have no coupon payments.
- 9) Treasury Bond - A long-term (5 years or more) promissory note, issued by the United States Treasury, secured by "the full faith and credit of the United States." They are sold initially through a primary market organized through the Federal Reserve. The coupon rate of interest paid on a Treasury bond is subject to legal constraints.
- 10) Treasury Note - A medium-term (1-10 years) promissory note issued by the United States Treasury, secured by "the full faith and credit of the United States." They are sold initially through a primary market organized through the Federal Reserve. The coupon rate of interest paid on a Treasury note is not subject to legal constraint.

- 11) The concept of state and local bonds, corporate bonds and utility bonds are identical to Treasury Bonds, except they are secured by the issuing organization and generally sold through commercial financial institutions.

Interest Rates in Money and Capital Markets and Consumer Price Index

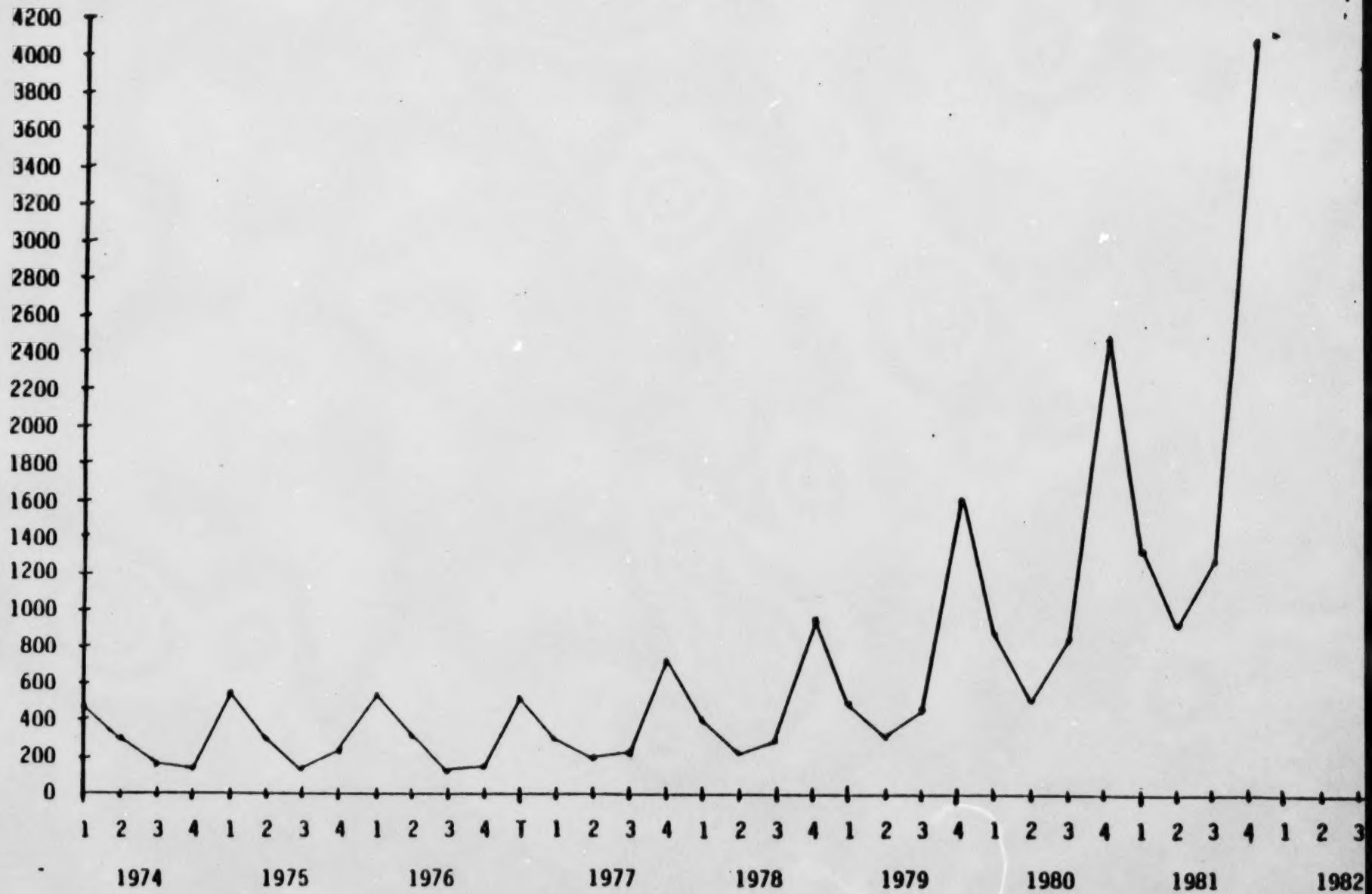
	70	71	72	73	74	75	76	77	78	79	80	81	82 ¹
CPI	5.9	4.3	3.3	6.2	11.0	9.1	5.0	6.5	7.7	11.3	13.5	9.8	
Prime Rate	7.91	5.72	5.25	8.03	10.01	7.06	6.04	6.03	9.06	12.67	15.27	15.75	14.39
Federal Funds	7.10	4.66	4.43	8.73	10.50	5.02	5.04	5.54	7.93	11.19	13.36	16.30	10.12
Commercial papers													
1-Month			4.43	8.19	10.19	6.06	4.99	5.42	7.76	10.86	12.76	15.69	9.50
3-Months			4.66	8.20	10.01	6.25	5.24	5.55	7.94	10.97	12.66	15.32	12.94
6-Months	7.71	5.11	4.73	8.15	9.04	6.32	5.34	5.61	7.99	10.91	12.29	14.76	10.00
Finance Papers													
1-Month	7.37	4.70	4.29	7.92	9.36	5.95	4.91	5.30	7.73	10.70	12.44	15.30	9.32
3-Months	7.10	4.89	4.55	7.41	8.65	6.15	5.20	5.49	7.00	10.47	11.49	14.00	9.62
6-Months	7.20	4.89	4.55	7.30	8.61	6.16	5.22	5.50	7.70	10.25	11.20	13.73	9.93
Certificates of Deposits													
1-Month	7.45	4.70	4.41	8.30	10.29	6.14	5.07	5.40	7.00	11.03	12.91	15.91	10.07
3-Months	7.56	4.99	4.67	8.41	10.24	6.44	5.27	5.64	8.22	11.22	13.07	15.91	10.61
6-Months	7.65	5.21	5.02	8.31	9.97	6.09	5.62	5.92	8.61	11.44	12.99	15.77	11.53
Treasury Bills													
3-Months	6.39	4.33	4.07	7.03	7.03	5.77	4.97	5.27	7.19	10.07	11.43	14.03	8.60
6-Months	6.48	4.51	4.40	7.20	7.94	6.09	5.25	5.53	7.50	10.06	11.37	13.00	9.00
1-Year	6.40	4.67	4.77	7.01	7.70	6.20	5.52	5.71	7.74	9.75	10.09	13.14	10.37
Treasury Notes & Bonds													
1-Year	6.90	4.00	4.96	7.31	8.10	6.76	5.00	6.09	8.34	10.67	12.05	14.70	11.43
3 to 5 Years	7.34	5.77	5.85	6.92	7.01	7.54	6.94	6.85	8.30	9.50	11.40	14.24	13.00
Over 10 Years	6.50	5.74	5.63	6.30	6.90	6.90	6.70	7.06	7.09	8.74	10.01	12.67	12.15
State & Local Bonds													
& Notes													
Aaa	6.12	5.22	5.04	4.99	5.09	6.42	5.66	5.20	5.52	5.09	7.05	10.43	10.60
Baa	6.75	5.89	5.60	5.49	6.53	7.62	7.49	6.12	6.27	6.73	9.01	11.76	12.36
Corporate Bonds													
Aaa	8.04	7.39	7.21	7.44	8.57	8.05	8.43	8.02	8.73	9.63	11.94	14.87	13.71
Aa	8.32	7.70	7.40	7.66	8.04	9.17	8.75	8.24	8.92	9.94	12.50	14.75	14.40
A	8.57	8.03	7.66	7.84	9.20	9.65	9.09	8.49	9.12	10.20	12.09	15.29	15.70
Baa	9.11	8.56	8.16	8.24	9.50	10.61	9.75	8.97	9.49	10.69	13.67	16.04	16.32
Aaa Utility Bonds	8.60	7.62	7.31	7.74	9.33	9.40	8.40	8.19	8.96	10.03	12.74	15.56	13.95
Discount Rate (as of 12/31)	5.5	4.5	4.5	7.5	7.75	6.0	5.25	6.0	9.5	12.0	13.0	12.0	10.0

Source: Board of Governors of the Federal Reserve System: 1) Annual Statistical Digest, 1970 - 1980, 2) "Federal Reserve Bulletin," January - August, 1982, U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States, 1981

¹As of August 31, 1982

GSLP Loan Volume
Quarterly Commitments
Fiscal Years 1974-1982

\$(Millions)



Fiscal Years